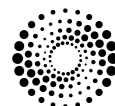


## **SELF-STUDY CONTINUING PROFESSIONAL EDUCATION**

**Companion to PPC's Guide to**

# **HUD AUDITS**



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# Interactive Self-study CPE

## Companion to PPC’s Guide to HUD Audits

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## INTRODUCTION

*Companion to PPC's Guide to HUD Audits* consists of 2 interactive self-study CPE courses. These are companion courses to *PPC's Guide to HUD Audits* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **OnlineGrading.Thomson.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **September 30, 2010**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

### Taking the Courses

Each course is divided into lessons. Each lesson addresses an aspect of HUD audits. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied that you understand the material, **answer the examination questions which follow each lesson**. You may either record your answer choices on the printed **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

### Qualifying Credit Hours—QAS or Registry

PPC is registered with the National Association of State Boards of Accountancy as a sponsor of continuing professional education on the National Registry of CPE Sponsors (Registry) and as a Quality Assurance Service (QAS) sponsor. Part of the requirements for both Registry and QAS membership include conforming to the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the standards). The standards were developed jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the standards. Each course is designed to comply with the standards. For states adopting the standards, recognizing QAS hours or Registry hours, credit hours are measured in 50-minute contact hours. Some states, however, require 100-minute contact hours for self study. Your state licensing board has final authority on accepting Registry hours, QAS hours, or hours under the standards. Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program or have adopted the standards and allow QAS CPE credit hours. Alternatively, you may visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours or have adopted the standards. Credit hours for CPE courses vary in length. Credit hours for each course are listed on the "Overview" page before each course.

CPE requirements are established by each state. You should check with your state board of accountancy to determine the acceptability of this course. We have been informed by the North Carolina State Board of Certified Public Accountant Examiners and the Mississippi State Board of Public Accountancy that they will not allow credit for courses included in books or periodicals.

### Obtaining CPE Credit

**Online Grading.** Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. You may search for the exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. For further instructions regarding the Online Grading Center, please refer to the Test Instructions preceding the Examination for CPE Credit Answer Sheet. A certificate documenting the CPE credits will be issued for each examination score of 70% or higher.

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You may fax your completed **Examination for CPE Credit Answer Sheet** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

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## COMPANION TO PPC'S GUIDE TO HUD AUDITS

## COURSE 1

## AUDITING COMPLIANCE WITH LAWS AND REGULATIONS (HUDTG091)

## OVERVIEW

**COURSE DESCRIPTION:** This interactive self-study course provides an overview of the current compliance environment, covers compliance auditing and requirements, addresses tests of controls over HUD programs, and specific compliance requirements for HUD-assisted projects. This course also deals with audit sampling in tests of controls over compliance, planning the extent of substantive tests of compliance, and a variety of other issues.

**PUBLICATION/REVISION DATE:** July 2009

**RECOMMENDED FOR:** Users of *PPC's Guide to HUD Audits*

**PREREQUISITE/ADVANCE PREPARATION:** Basic knowledge of auditing

**CPE CREDIT:** 8 QAS Hours, 8 Registry Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at [www.nasba.org](http://www.nasba.org) for a listing of states that accept QAS hours.

**Yellow Book CPE Credit:** This course is designed to assist auditors in meeting the continuing education requirements included in GAO's Government Auditing Standards.

**FIELD OF STUDY:** Auditing (Governmental)

**EXPIRATION DATE:** Postmark by **September 30, 2010**

**KNOWLEDGE LEVEL:** Basic

**Learning Objectives:****Lesson 1—The Current Compliance Environment, Compliance Auditing Concepts, Identifying and Auditing Compliance Requirements, and Tests of Controls Over HUD Programs**

Completion of this lesson will enable you to:

- Define the compliance environment and compliance auditing concepts.
- Perform a HUD compliance audit and property test controls over HUD programs.

**Lesson 2—Specific Compliance Requirements for HUD-Assisted Projects, Audit Sampling in Tests of Controls Over Compliance, and Planning the Extent of Substantive Tests of Compliance**

Completion of this lesson will enable you to:

- Summarize compliance requirements for HUD-assisted projects.
- Utilize audit sampling in tests of controls over compliance.

**TO COMPLETE THIS LEARNING PROCESS:**

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation**, and payment to:

**Thomson Reuters  
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HUDTG091 Self-study CPE  
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Chicago, IL 60694-6700**

See the test instructions included with the course materials for more information.

**ADMINISTRATIVE POLICIES:**

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# Lesson 1: The Current Compliance Environment, Compliance Auditing Concepts, Identifying and Auditing Compliance Requirements, and Tests of Controls Over HUD Programs

## INTRODUCTION

### Tests of Compliance

This lesson explains how to plan and perform tests of compliance with laws and regulations governing for-profit project owners that receive assistance under a HUD program. Portions of this lesson may also apply to nonprofit entities.

The HUD audit guide goes beyond GAAS and the *Government Auditing Standards* in requiring auditors to test, and issue an opinion on, compliance with laws and regulations that have a direct and material effect on each major HUD program. Thus, the auditor must do enough testing of major programs to provide a sufficient basis for expressing an opinion on compliance related to major HUD programs.

The HUD audit guide provides less guidance on the extent of testing required for nonmajor programs.

### Learning Objectives:

Completion of this lesson will enable you to:

- Define the compliance environment and compliance auditing concepts.
- Perform a HUD compliance audit and properly test controls over HUD programs.

### Tests of Controls over Compliance

In addition to compliance testing, the HUD audit guide also requires auditors to test the entity's controls relevant to the administration of HUD programs.

### Sampling

Tests of compliance and tests of controls may involve sampling.

### Authoritative Literature

The authoritative literature that is relevant to compliance auditing for HUD-assisted entities includes both AICPA pronouncements and government pronouncements.

The following government pronouncements provide guidance on HUD compliance auditing:

- GAO *Government Auditing Standard, 2007 Revision* (the Yellow Book), incorporates GAAS and adds additional reporting requirements concerning compliance with laws and regulations and internal control.
- *Consolidated Audit Guide for Audits of HUD Programs* (the "HUD audit guide") suggests procedures for testing the specific requirements governing each HUD program. It also requires auditors to test controls to evaluate the effectiveness of the design and operation of internal control in preventing or detecting material noncompliance with the requirements of HUD programs.
- SAS No. 54 (AU 317), *Illegal Acts by Clients*, establishes the auditor's responsibilities concerning laws and regulations that have a direct and material effect on the determination of financial statement amounts and those that do not have a direct effect.

- SAS No. 55 (AU 319), *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, provide guidance to auditors related to consideration of internal control required in all audits and on tests of controls required in certain circumstances of a GAAS audit.
- SAS No. 74 (AU 801), *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*, provides general guidance to practitioners engaged to test and report on compliance with laws and regulations under GAAS, GAO *Government Auditing Standards*, and federal audit requirements.
- SAS No. 99 (AU 316), *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to consider the risk of material misstatement due to fraud and to design the audit to provide reasonable assurance of detecting fraud that results in the financial statements being materially misstated.
- AICPA Audit Guide, *Government Auditing Standards and Circular A-133 Audits* (GAS/A-133 AICPA Audit Guide) provides guidance for financial statement audits performed under *Government Auditing Standards* (such as for-profit and nonprofit HUD entities) in Part I. Guidance for audits conducted under the Single Audit Act and OMB Circular A-133 (nonprofit HUD entities only) is provided in Part II.

The authoritative pronouncements that establish requirements or provide suggestions that most directly affect the use of audit sampling are as follows:

- SAS No. 39 (AU 350), *Audit Sampling*, as amended by SAS No. 111, *Amendment to Statement on Auditing Standards No. 39, Audit Sampling*.
- AICPA Audit Guide, *Audit Sampling* (the AICPA Sampling Guide).
- HUD Audit Guide, Chapter 3.
- OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.
- AICPA Audit Guide, *Government Auditing Standards and Circular A-133 Audits* (GAS/A-133 AICPA Audit Guide).

The remainder of this lesson discusses audit procedures that comply with the authoritative literature referred to above. Each engagement, however, is unique. Therefore, auditors should tailor the procedures discussed in this chapter for the unique aspects of each engagement.

### July 2008 Revisions to the HUD Audit Guide

The *Consolidated Audit Guide for Audits of HUD Programs*, issued in December 2001, is being updated by the HUD Office of Inspector General chapter by chapter to clarify reporting requirements, suggested audit steps and existing information and guidance, and to incorporate changes in professional standards.

In July 2008, HUD released Chapter 3, "HUD Multifamily Housing Programs," of the HUD audit guide, which is a revision and update of the previous Chapter 4 of the same title. In its transmittal letter accompanying the chapter, HUD stated the requirements in the new chapter are effective and could be used upon issuance, and *must* be applied to audits of for-profit HUD-assisted entities with fiscal years ending on or after December 31, 2008. The HUD audit guide and updated chapters are available on HUD's website at [www.hud.gov/offices/oig/reports/auditguide/](http://www.hud.gov/offices/oig/reports/auditguide/).

Chapter 3 of the HUD audit guide covers HUD's requirements for conducting the compliance portion of annual audits of for-profit HUD entities. In addition to the revisions to existing compliance procedures, the new chapter includes the following significant changes:

- Compliance requirements are added or reinstated for:
  - Equity Skimming

- Cash Receipts
- Cash Disbursements
- Units Leased to Extremely Low-Income Families
- Tenant Security Deposits
- Leased Nursing Homes
- Mark-to-Market Program (M2M)
- Section 236 Decoupling Projects
- Group project-based sampling is allowed for three compliance areas when audits are performed for projects that are owned and/or managed by the same owner and/or management agent.
- The attribute sampling methodology is required when the HUD audit guide's suggested audit procedures require sampling. The revised chapter provides specific guidance about sample selection and sample sizes.
- Reporting requirements are updated to conform with the requirements of *Government Auditing Standards*.
- New guidance on reporting instances of nonmaterial noncompliance is provided.
- Two appendixes on the topics of attribute sampling and equity skimming are provided.
- A list of the HUD handbooks referenced within the chapter is provided.
- Contact information for technical assistance is provided.

During a webcast sponsored by the AICPA's Governmental Audit Quality Center (GAQC) in November 2008, a representative from the HUD OIG provided comments about the reasons for many of the changes made in the revision of Chapter 3 of the HUD audit guide. The HUD OIG representative stated that OIG audits of HUD—assisted projects found several common problems with compliance with HUD program requirements. The HUD OIG addressed these problem areas by adding or modifying suggested audit procedures in the HUD audit guide. Some of these problems include:

- Unallowed costs charged to projects,
- Many projects operated by the same management entity but all indirect costs charged to one project, cost distributions were arbitrary and not supportable,
- Owner made cash withdrawals when project was not in "surplus cash" position,
- Surplus cash withdrawn at other than allowed semiannual or annual fiscal periods,
- Funds withdrawn by owner and replaced at end of reporting period,
- Disbursements made from the reserve for replacement account without HUD approval,
- Unsupported disbursements,
- Project funds improperly loaned to related entities,
- Missing tenant eligibility documentation and missing tenant file documentation,

- Unsupported housing assistance payments,
- Appropriate accounting procedures and controls at the project had not been established,
- Financial activities of the owner commingled in the project accounting records,
- Laundry and other income diverted to the owner,
- Management fees in excess of HUD—approved amounts, and
- Equity skimming.

The discussions provided in this course are designed to assist the auditor with detecting potential areas of noncompliance, such as those listed by the HUD OIG.

The new guidance and requirements provided by HUD in Chapter 3 are discussed in more detail in the relevant sections of this lesson.

### **Types of Projects Subject to the Compliance Requirements in Chapter 3 of *Consolidated Audit Guide for Audits of HUD Programs***

For-profit projects that receive financial assistance under a HUD multifamily housing program must be tested for compliance with the requirements set forth in Chapter 3 of the *Consolidated Audit Guide for Audits of HUD Programs*.

A project is not subject to the HUD audit guide if the *only* assistance it receives from HUD is received under one of the following programs:

- Section 8 Existing Housing Program (24 CFR 882, subparts A and B).
- Section 8 Moderate Rehabilitation Projects (24 CFR 882, subparts D and E).
- Shelter Plus Care Rental Assistance (assistance to homeless persons) (CFR 583).
- Housing Opportunities for Persons With AIDS (CFR 574).
- Housing assistance under the HOME Investment Partnership Act.
- Housing assistance under the “Housing Opportunities for People Everywhere” (HOPE) multifamily housing program.
- Section 8 for Single Room Occupancy (CFR 882, subpart H).

Such projects would, however, still be subject to the compliance requirements in *Government Auditing Standards*. While projects under the Section 8 for Single Room Occupancy Program (listed above) generally do not have to follow the HUD audit guide, the following projects must follow the HUD audit guide:

- Projects assisted under the Section 8 new construction or substantial rehabilitation programs.
- Loan management and property disposition set-aside projects.
- Projects with HUD-insured or coinsured mortgages.

HUD may contract with state housing finance agencies to administer a Section 8 rent subsidy program on HUD's behalf. As contract administrators, state housing finance agencies perform their own compliance reviews of the assisted entities and may request that the entities engage the auditor to conduct only a financial audit. Auditors should inquire of the state housing finance agency about whether it desires both a financial and compliance audit,

or just a financial audit. Some state housing finance agencies have developed their own audit guides for HUD-assisted entities.

### **Should Nonprofit Recipients of HUD Assistance Follow the HUD Audit Guide or OMB Circular A-133?**

Nonprofit entities are included in the scope of the amended Single Audit Act and OMB Circular A-133 and are directed by Paragraph 1-1 of the HUD audit guide to obtain an audit in accordance with OMB Circular A-133.

Much of this lesson is directed at compliance with provisions of the HUD audit guide. These provisions apply only to for-profit entities. However, portions of this lesson also address compliance auditing of a general nature that is applicable to both for-profit and nonprofit entities. Not all of the HUD-assisted multifamily programs are included in the *OMB Circular A-133 Compliance Supplement* (Compliance Supplement).

### **Determination of Major Programs**

**For-profit Entities.** The auditor is required to express an opinion on compliance with requirements applicable to major HUD programs. When a for-profit entity receives assistance in excess of \$300,000 in a year under a HUD program, that program is considered a major HUD program. For example, if a project receives over \$300,000 in Section 8 assistance in a year, the Section 8 program is a major program. Also, according to the HUD audit guide, if the outstanding balance exceeds \$300,000 under a flexible subsidy program or an insured or coinsured loan program, the program is a major program.

**Nonprofit Entities.** The auditor is also required to express an opinion on compliance with requirements applicable to major HUD programs for nonprofit entities. Major programs for nonprofit entities are determined by a risk-based approach. According to Housing Notice 98-25, nonprofit entities should include the total unpaid principal balances of all mortgages or capital advances as of the end of the fiscal year (insured, direct, and HUD-held loans) in the calculation of what is considered a major program.

## **CURRENT TRENDS IN THE COMPLIANCE ENVIRONMENT**

The following paragraphs highlight current trends in the compliance environment relevant to audits of HUD-assisted entities.

### **Concerns with Substandard Audits**

**HUD Office of Inspector General.** The HUD Office of Inspector General (HUD OIG) is responsible promoting the integrity, efficiency and effectiveness of HUD programs. One of the office's responsibilities is to issue and update the HUD audit guide. Accordingly, the HUD OIG is concerned with audit quality and uses the results of its audit documentation reviews to monitor how auditors are using the HUD audit guide and meeting the professional and regulatory requirements. During a webcast sponsored by the AICPA's Governmental Audit Quality Center (GAQC) in November 2008, a representative from the HUD OIG provided comments about the reasons for many of the changes made in the 2008 revision to Chapter 3 of the HUD audit guide. New procedures and requirements were added to address audit weaknesses revealed during OIG reviews of audit documentation. These weaknesses include:

- Deficiencies in acceptable auditing criteria, poor audit documentation, and insufficient sample sizes;
- Insufficient tests of compliance, pointing to a need for increased focus on auditing cash receipts, cash disbursements, and tenant security deposits;
- Evidence of equity skimming and other compliance failures going undetected; and
- Incomplete audit programs and audit programs not appropriately customized.

Many of the new compliance audit procedures that were added in the revision of Chapter 3 of the HUD audit guide are the result of the HUD OIG's determination that insufficient audit work to support the auditor's report on

compliance was being performed and adverse compliance conditions were going undetected. The HUD OIG believes there will be more consistency in the amount of audit work performed in HUD audits and overall audit quality will improve as a result of adding the additional requirements in the HUD audit guide.

On numerous occasions the Government Accountability Office (GAO) has advised Congress that the quality of independent auditor performance has been less than satisfactory, with specific emphasis on audits of HUD-assisted projects. Due to the extent of audit quality problems found by various agency inspectors general, an interagency, interdisciplinary task force was created to oversee a federal study on the quality of audits performed under Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.

**Findings on Sampling from the Single Audit Quality Study.** The President's Council on Integrity and Efficiency (PCIE) and the Executive Council on Integrity and Efficiency (ECIE) released the "Report on National Single Audit Sampling Project" (the Report) in June 2007. Among the Report's findings was that proper sampling techniques had not been applied in many of the Single Audits reviewed. Specifically, the report noted that inconsistent numbers of transactions were being selected for testing of internal controls and compliance testing for the allowable costs/cost principles compliance requirement. In addition, many auditors did not document the number of transactions and the associated dollars of the universe from which the transactions were drawn. In its most recent Audit Risk Alert, *Government Auditing Standards and Circular A-133 Audits—2008*, the AICPA also indicates that applying improper sampling techniques is a common deficiency found in recent peer reviews of audit firms made by its Professional Ethics Division.

The Report discusses a need to provide for consistency in sample sizes and recommends that OMB and AICPA guidance be amended to require that compliance testing in Single Audits be performed using sampling in a manner prescribed by SAS No. 39, as amended. Among other things, the Report also recommends specific documentation requirements and indicates that guidance should include examples that illustrate proper documentation based on real compliance requirements and situations typically encountered when performing a Single Audit. The Report is available at [www.ignet.gov/pande/audit/NatSamProjRptFINAL2.pdf](http://www.ignet.gov/pande/audit/NatSamProjRptFINAL2.pdf).

Several AICPA and federal task forces have been formed to respond to the Report's recommendations. These projects could result in revisions to the professional standards, AICPA Audit Guides, OMB requirements, and other standards, regulations, and guidance.

**Deficiencies in HUD Audits.** Previous editions of the AICPA Audit Risk Alert, *Government Auditing Standards and Circular A-133 Audits*, highlighted the following common deficiencies in HUD audits found during recent peer reviews and AICPA Professional Ethics Division investigations that apply to auditing compliance:

- Incorrect use of the HUD audit guide to satisfy OMB Circular A-133 requirements.
- Insufficient audit work performed to support the opinion of many projects managed by the project owner/management agent. This finding is based in part on the fact that some auditors did not audit compliance requirements of each project, but instead tested requirements of some projects, applying the results from those projects as if they applied as well to the untested projects. Auditors are warned that HUD limits this type of testing in its revision of Chapter 3 of the HUD audit guide.

The Risk Alerts have also stated that HUD's settlement with six firms since 2003 reinforces the federal government's strong emphasis on ensuring financial accountability and the importance of firms taking appropriate steps to ensure they do not have any quality issues. In this regard, HUD has taken steps to refer firms to state boards of accountancy and the AICPA.

With respect to audits of public housing authorities (PHAs), HUD has taken additional steps to improve its oversight of HUD audit quality, including referring firms to state boards of accountancy and the AICPA, and using new methods of audit verification to determine whether the audit firms identified all material instances of noncompliance with federal laws, regulations, and contract provisions.

Auditors performing audits of nonprofit HUD entities should carefully review their single audit engagements to ensure that they have met all current applicable professional standards.



### **Creative Compensation Arrangements Involving Identity-of-interest Entities**

Some affiliates of HUD-assisted entities have established *creative* compensation arrangements involving identity-of-interest companies. One typical arrangement involves a general partner in a HUD-assisted project who also serves as the management agent and attempts to extract profits from related party service contracts through artificially inflated fees for services rendered to the project.

### **Increased Participation in HUD Programs by Nonprofit Entities**

The Sections 202 and 811 “new construction” programs have attracted an eclectic group of sponsoring organizations ranging from local religious organizations to community organizations for the developmentally disabled. Auditors should be aware that such organizations often lack an awareness of compliance issues; for example, a church-affiliated sponsor of a Section 202 project for the elderly may unknowingly give preferential consideration to the elderly members of its congregation when processing applications.

### **Trend Toward Greater CPA Involvement in the Detection of Noncompliance**

HUD has downsized dramatically in recent years, and with fewer personnel available to conduct inspections of project owners, HUD is increasingly looking to auditors to be its “partner” in detecting noncompliance with HUD laws and regulations. One example of this is the CPA certification requirement relating to the electronic submission of the project owner’s financial information. It is expected that this trend toward greater CPA involvement will continue, with special emphasis in the areas of tenant eligibility and nondiscrimination in applicant screening, maintenance of property, and misuse of funds.

### **Program Fraud Alerts**

“Program Fraud Alerts” are notices issued by the HUD OIG to address national trends in housing fraud. A Program Fraud Alert was issued to discuss violations of applicable statutes and HUD requirements involving equity skimming. Equity skimming is broadly defined in the alert as “the misuse or diversion of project assets or income by project owners or management agents.” Equity skimming results in the realization of losses to the FHA insurance funds and deprives projects of needed funds for repairs and maintenance.

The regulatory agreement between the project owner and HUD specifies that expenditures must be “reasonable and necessary to the project” and limits the cash or other assets the owner may take out of the project. Therefore, the use of project assets or income for other than reasonable operating expenses and necessary repairs or for the payment of unauthorized distributions to the owner constitutes a violation of the regulatory agreement.

The civil penalty for the use of project funds in violation of the regulatory agreement can be double the value of any assets or income of a project that was used in violation of the regulatory agreement plus reasonable attorney and audit fees. HUD can seek to recover those damages against project owners who use project assets or income and do not maintain adequate supporting documentation for the expenditure. HUD does not have to prove criminal intent.

The misuse of project funds can also be prosecuted as a criminal matter if the equity skimming occurs “in a period during which the mortgage note is in default or the project is in a nonsurplus cash position, as defined by the regulatory agreement.” Violation of this provision is a felony and can be punished by up to five years imprisonment and fines up to \$500,000.

If the project is in a nonsurplus cash position or is in default, the following actions could constitute equity skimming:

- Cash distributions or withdrawals.
- Repayment of advances made to the project by the owner or management agent.
- Lending funds to owners, partners, affiliates, or the management agent.
- Payments of principal and/or interest on any secondary financing without HUD approval.

- Sharing of management fees with the project owner.
- Purchasing equipment or services not for use by the project with project funds.
- Paying more for services and supplies than could be procured on the open market.
- Payment of construction or rehabilitation costs from operations instead of mortgage proceeds.
- Payments to consultants, attorneys, or accountants for partnership activities that are not reasonable and necessary operating expenses of the project.
- Personal or other business loan payments.

Auditors should be alert for these actions when performing the audit.

### **Executive Order 13166, “Improving Access to Services for Persons With Limited English Proficiency”**

On August 11, 2000, Executive Order 13166 titled “Improving Access to Services for Persons With Limited English Proficiency” was issued. While the Executive Order does not impose any new requirements on Federal agencies, it requires greater emphasis on existing requirements under Title VI of the Civil Rights Act to protect people who may face discrimination based on national origin. Federal agencies are directed to assess and address the needs of those that seek access to federally conducted programs and activities and who, due to limited English proficiency (LEP), cannot fully and equally participate in or benefit from those programs and activities. HUD has many programs aimed at promoting adequate and affordable housing, economic opportunity, and a suitable living environment for every American free from discrimination. HUD's implementation plan with regard to Executive Order 13166 focuses on ensuring that people with limited English proficiency have meaningful access to HUD programs and activities.

Accordingly, on January 22, 2007 HUD published a notice in the *Federal Register* which provides “Final Guidance to Federal Financial Assistance Recipients Regarding Title VI Prohibition Against National Origin Discrimination Affecting Limited English Proficient Persons (LEP).” The guidance is effective immediately and applies to all HUD projects which receive project-based assistance, as well as projects which receive HOME and CDBG assistance. For further information see [www.hud.gov/offices/fheo/promotingfh/lep.cfm](http://www.hud.gov/offices/fheo/promotingfh/lep.cfm). This website includes the *Federal Register* notice, as well as LEP FAQs for the multifamily housing industry.

### **Legislative Change Affecting Multifamily Housing Programs**

On October 21, 1998, the President signed into law the Quality Housing and Work Responsibility Act of 1998 (“QHWRA”) to implement certain provisions of the HUD 2020 Management Reform Plan. Selected effects on multifamily housing programs are as follows:

- a. *Minimum Section 8 Rent.* The minimum monthly Section 8 rent is statutorily set at \$25 per family. However, QHWRA provides for the following exceptions to the minimum rent requirement based on the following hardship conditions:
  - (1) The family has lost eligibility or is awaiting an eligibility determination for a federal, state, or local assistance program.
  - (2) The family would be evicted as a result of the imposition of the minimum rent requirement.
  - (3) The income of the family has decreased because of changed circumstances, such as loss of employment.
  - (4) A death in the family has occurred.

The mandatory exceptions are retroactive to October 21, 1998 and the statute requires project owners to make retroactive adjustments for eligible families.



- b. *Repeal of Mandatory Federal Preferences.* Project owners are not required to give preference to applicants who qualify for the previously mandated nonstatutory federal preference categories of involuntary displacement, substandard housing, or excessive rent burden. Though not required to do so, project owners may use certain preferences.
- c. *Law Enforcement and Security Personnel.* Project owners must apply to the HUD field office for authorization to house over-income police officers and other security personnel.
- d. *Advance Notice to Tenants.*
  - (1) Project owners are not required to provide a 90-day notice to tenants of any rent increase that may occur as a result of the expiration or termination of a contract.
  - (2) Project owners are required to provide at least one-year written notification to tenants and to HUD of the expiration or termination of a contract. (QHWRA provides for short-term contract renewals when inadequate time remains on the contract to fulfill the full one-year notification period and the project owner does not wish to sign another one-year contract to fulfill the notification requirement.)
  - (3) Owners of properties considered eligible low-income housing who prepay the mortgage or terminate mortgage insurance for those properties must provide certain parties with at least 150 days, but not more than 270 days, written notice of their intent to prepay the mortgage.
- e. *Tenant Participation in Multifamily Housing Projects.* This section of the statute extends the rights of tenants to form tenant organizations in all projects receiving project-based Section 8 assistance and tenants receiving “enhanced vouchers” under the various low-income housing acts.

Housing Notice 00-18 contains the implementing regulations for QHWRA. In addition to implementing the provisions listed above, it provides additional guidance on income targeting and preference requirements as follows:

- a. *Income Targeting.* Tenant selection plans for project-based Section 8 assistance must be designed so that at least 40% of the units becoming available each federal fiscal year are reserved for eligible applicants with extremely low incomes (30% or less than the area median income). Reserved units must first be made available to extremely low-income applicants currently on the waiting list. Project owners are required to actively market the units to extremely low-income families and may only fill the units with other eligible applicants after a reasonable marketing period has expired. Project owners must maintain records demonstrating compliance with these requirements. In addition, the following income limits apply:
  - (1) Not more than 25% of the units (originally) available for occupancy prior to October 1, 1981 shall be rented to low-income families (less than 80% of the median income), other than very low income families (less than 50% of the median income).
  - (2) Not more than 15% of the units (originally) available for occupancy after September 30, 1981 shall be rented to low-income families (less than 80% of the median income), other than very low-income families (less than 50% of the median income).
- b. *Preferences.* Though mandated nonstatutory federal preference requirements are eliminated, project owners may choose to use the following preferences:
  - (1) Households with an employed member.
  - (2) Residents of the preferred area, with prior HUD approval.
  - (3) Other preferences that are part of a written plan and that are nondiscriminatory, such as the disabled, victims of domestic violence, and single persons age 62 or older that are homeless or disabled.

The Section 8 Renewal Policy Guide Book establishes contract renewal policy for expiring Section 8 contracts.

## Considerations for the American Recovery and Reinvestment Act of 2009

The American Recovery and Reinvestment Act of 2009 (Recovery Act) enacted in February 2009 provides approximately \$13.6 billion for projects and programs administered by HUD.

With respect to audits of HUD-assisted for-profit entities, generally there are three aspects of the Recovery Act that have implications when auditing compliance for Recovery Act award recipients as follows:

- a. Program-specific requirements
- b. Recovery Act reporting requirements, including requirements for tracking and reporting Recovery Act funds separately
- c. Internal control considerations

**Program-specific Requirements.** Both profit-motivated and nonprofit multifamily HUD project owners are eligible for the following Recovery Act programs administered by HUD:

- *The Green Retrofit Program for Multifamily Housing*
- *The Project-Based Rental Assistance Program*

Green Retrofit Program for Multifamily Housing. The Green Retrofit Program for Multifamily Housing is a grant and loan program available for HUD-assisted projects that have already received assistance under Section 202 of the Housing Act of 1959, Section 811 of the Cranston-Gonzalez National Affordable Housing Act, or Section 8 of the United States Housing Act of 1937. Only nonprofit HUD-assisted entities, which require Single Audits under OMB Circular A-133, are eligible to participate in the Section 202 and Section 811 programs.

For-profit HUD-assisted entities that participate in Section 8 rental assistance programs and that participate in the Green Retrofit Program should determine whether the Green Retrofit award is a major HUD program. If the award is a major HUD program, the auditor is required to express an opinion on compliance and should use the HUD audit guide as the basis for compliance audit procedures. The auditor should also review the program documents for specific compliance requirements. There are some projects that receive certain types of Section 8 support as the only HUD assistance and, accordingly, are not subject to the HUD audit guide. If those Section 8 projects obtain an award under the Green Retrofit Program, the auditor should consider whether they become subject to the Uniform Financial Reporting Standards and will need to submit audited annual financial statements to HUD. *Government Auditing Standards* and the requirements of the HUD audit guide, (if the award is a major HUD program), may then apply.

Project-Based Rental Assistance Program. The Project-Based Rental Assistance Program is not really a new program; the Recovery Act was used to appropriate approximately \$2 billion to renew existing Section 8 housing assistance contracts. Both for-profit and nonprofit entities are eligible for Section 8 assistance. Since this Recovery Act program funds existing HUD contracts, there are no new program requirements for the auditor to consider, although the auditor should consider the Recovery Act reporting requirements discussed below. The applicable compliance audit procedures required by the HUD audit guide or by the OMB Circular A-133 Compliance Supplement should be followed.

**Recovery Act Reporting Requirements.** A significant aspect of the Recovery Act is the reporting requirement designed to provide transparency and accountability for expenditure of Recovery Act funds. Beginning with the quarter ended June 30, 2009, recipients of HUD-administered Recovery Act funds are required to report certain information to HUD within 10 days after the end of each quarter. HUD has established an internet-based reporting system for this reporting process. The Recovery Act Management and Performance (RAMPS) data system is accessible at [http://portal.hud.gov/app\\_ramps/](http://portal.hud.gov/app_ramps/).

HUD states that Recovery Act funds can be used in conjunction with other funding as necessary to complete projects, but separate tracking and reporting of these funds must be made to meet the reporting requirements of the Recovery Act and the related OMB guidance. The special reporting requirements imposed by the Recovery Act

make it important for award recipients to separately track Recovery Act funds from the time they are received. The authors believe it will be necessary for the auditor to consider the Recovery Act's reporting requirements when auditing compliance.

**Internal Control Considerations.** Federal officials have expressed concerns about whether recipients' internal controls will be able to cope with the increased funding from Recovery Act awards. Apparently, the guidance from the AICPA's Governmental Audit Quality Center's GAQC Alert No. 106, *Effect of American Recovery and Reinvestment Act of 2009 on Single Audits*, should be considered. The GACQ Alert suggests that auditors may want to advise their clients that expect to receive Recovery Act funds to consider the following:

- Whether their internal control procedures for federal expenditures are appropriate, working properly, and designed to prevent unallowable expenditures.
- Whether they need additional controls and system changes in order to separately identify and track Recovery Act funds.
- Whether they need new controls in order to meet the new requirements for reporting back to federal agencies.

**Further Recovery Act Developments.** Many aspects of the Recovery Act had not been finalized at the time this course was completed. HUD and other governmental agencies can be expected to issue additional guidance over the coming months. HUD has established a website to provide information about all aspects of its administration of Recovery Act funds at [www.hud.gov/recovery/](http://www.hud.gov/recovery/). Auditors are encouraged to monitor these websites to stay current with Recovery Act developments.

## COMPLIANCE AUDITING BASIC CONCEPTS

This section explains the terms and concepts that are generally applicable to compliance auditing.

The following aspects of compliance auditing are discussed in this section:

- Responsibility for laws and regulations in all audits.
- Responsibility for laws and regulations in a HUD audit.
- Tests of compliance versus other audit tests.
- Transaction-related versus program-related requirements.
- Relation of compliance tests to internal controls.

### Responsibility for Laws and Regulations in All Audits

In any audit made in accordance with GAAS, the auditor's responsibility concerning errors, fraud, and illegal acts relates to their possible effect on the financial statements. SAS Nos. 54 and 82 define that responsibility. SAS No. 99 (AU 316.01) states the following:

The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.

SAS No. 54 at AU 317.05–.07 states:

.05The auditor considers laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts. . . . The auditor's responsibility to detect and report misstatements resulting from illegal acts having a direct and

material effect on the determination of financial statement amounts is the same as that for misstatements caused by error or fraud as described in section 110, *Responsibilities and Functions of the Independent Auditor*.

.06 Entities may be affected by many other laws or regulations, including those related to securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment, and price-fixing or other antitrust violations. Generally, these laws and regulations relate more to an entity's operating aspects than to its financial and accounting aspects, and their financial statement effect is indirect. An auditor ordinarily does not have sufficient basis for recognizing possible violations of such laws and regulations. Their indirect effect is normally the result of the need to disclose a contingent liability because of the allegation or determination of illegality. . . . Even when violations of such laws and regulations can have consequences material to the financial statements, the auditor may not become aware of the existence of the illegal act unless he is informed by the client, or there is evidence of a governmental agency investigation or enforcement proceeding in the records, documents, or other information normally inspected in an audit of financial statements.

.07. . . If specific information comes to the auditor's attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred. However, because of the characteristics of illegal acts explained above, an audit made in accordance with generally accepted auditing standards provides no assurance that illegal acts [that have indirect effects on the financial statements] will be detected. . . .

### **Responsibility for Laws and Regulations and Other Matters under *Government Auditing Standards***

The HUD audit guide requires the auditor to follow the Yellow Book standards for financial audits. The discussion at Paragraphs 4.27–28 of the Yellow Book points out that both GAAS and Yellow Book audits indicate auditors should plan to perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. In addition, auditors are required to design the audit to provide reasonable assurance of detecting misstatements resulting from illegal acts that could have a direct and material effect on the financial statements. If specific information comes to the auditor's attention that provides evidence about a possible illegal act that could have a material *indirect* effect on the financial statements, the auditor should apply additional procedures intended to determine if an illegal act has occurred. If an illegal act has or is likely to have occurred, the auditor should determine the effect on the financial statements and the implications for other aspects of the audit. (The Yellow Book does, however, contain reporting requirements related to compliance and abuse that go beyond GAAS.)

The Yellow Book, Paragraphs 4.10–.11, extends the auditor's consideration of laws and regulations to include compliance with provisions of contracts and agreements as follows:

Auditors should design the audit to provide reasonable assurance of detecting misstatements that result from violations of *provisions of contracts or grant agreements* and could have a *direct and material effect* on the determination of financial statement amounts or other financial data significant to the audit objectives.

If specific information comes to the auditors' attention that provides evidence concerning the existence of possible violations of provisions of contracts or grant agreements that could have a *material indirect effect* on the financial statements, the auditors should apply audit procedures specifically directed to ascertaining whether such violations have occurred. When the auditors conclude that a violation of provisions of contracts or grant agreements has or is likely to have occurred, they should determine the effect on the financial statements as well as the implications for other aspects of the audit. [Emphasis added.]

This means that in Yellow Book engagements, auditors have the same responsibilities for detecting material misstatements arising from violations of provisions of contracts or grant agreements as they do for detecting those arising from fraud and illegal acts.

**Abuse.** The Yellow Book contains an additional fieldwork standard that requires auditors to perform additional procedures if they become aware of abuse that could be quantitatively or qualitatively material to the financial statements. The following paragraphs discuss the Yellow Book requirements and related guidance in the GAS/A-133 AICPA Audit Guide.

Paragraph 4.12 of the Yellow Book notes that abuse may not involve fraud, illegal acts, or violations of provisions of contracts or grant agreements. It states:

Abuse involves behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances. Abuse also includes misuse of authority or position for personal financial interests or those of an immediate or close family member or business associate. Abuse does not necessarily involve fraud, violations of laws, regulations, or provisions of a contract or grant agreement.

Based on the Yellow Book's definition of abuse, what constitutes abuse or potential abuse is not clear and will be open to interpretation. However, in Appendix I, Paragraph A.06, the Yellow Book provides the following examples of actions that may represent abuse, depending on the relevant facts and circumstances:

- Creating unneeded overtime.
- Requesting staff to perform personal errands or work tasks for a supervisor or manager.
- Misusing the official's position for personal gain (including actions that could be perceived by an objective third party with knowledge of the relevant information as improperly benefiting an official's personal financial interests or those of an immediate or close family member; a general partner, an organization for which the official serves as an officer, director, trustee, or employee; or an organization with which the official is negotiating concerning future employment).
- Making travel choices that are contrary to existing travel policies or are unnecessarily extravagant or expensive.
- Making procurement or vendor selections that are contrary to existing policies or are unnecessarily extravagant or expensive.

**Auditors' Responsibilities Relating to Abuse.** The GAS/A-133 AICPA Audit Guide explains that, although situations or transactions involving federal awards might appear to constitute abuse they usually are instances of noncompliance. The determination of abuse is subjective; therefore auditors are not required to provide reasonable assurance of detecting abuse. However, if the auditor detects abuse, Paragraph 4.13 of the Yellow Book provides the following fieldwork standard:

If during the course of the audit, auditors become aware of abuse that could be quantitatively or qualitatively material to the financial statements, auditors should apply audit procedures specifically directed to ascertain the potential effect on the financial statements or other financial data significant to the audit objectives. After performing additional work, auditors may discover that the abuse represents potential fraud or illegal acts. Because the determination of abuse is subjective, auditors are not required to provide reasonable assurance of detecting abuse.

The GAS/A-133 AICPA Audit Guide, at paragraph 3.35, provides the following guidance to auditors on their responsibilities relating to abuse:

- If the auditors conclude that a situation or transaction indicates that abuse may have occurred, auditors should evaluate whether the possible abuse could materially affect financial statement amounts or other financial data.



- If possible abuse could materially affect the financial statement amounts or other financial data, the auditors should extend audit procedures (such as extending sample sizes by selectively choosing additional testing items) as necessary.
- Auditors should consider both quantitative and qualitative factors in making judgments regarding the materiality of possible abuse and whether they need to extend the audit procedures. Qualitative factors may include whether the abuse is the result of an internal control deficiency, involves collusion or concealment, or is an isolated event. Additional qualitative factors are discussed in Paragraph 3.36 of the GAS/A-133 AICPA Audit Guide.

Auditors do not have a responsibility to detect abuse under either GAAS or *Government Auditing Standards*. However, the Yellow Book establishes a presumptively mandatory requirement to perform certain additional procedures if information comes to their attention indicating that abuse may have occurred.

**Material Abuse Relating to the Financial Statements or Other Financial Data.** Paragraph 5.10 of the Yellow Book indicates auditors should report, as applicable to the objectives of the audit, abuse that could have a material effect on the financial statements. Paragraph 5.15 further states that auditors should include relevant information in their audit report about abuse when they conclude, based on sufficient, appropriate evidence, that abuse that is either quantitatively or qualitatively material occurred or is likely to have occurred.

**Abuse Relating to Federal Awards.** The Yellow Book fieldwork standard that requires auditors to apply additional procedures if they become aware of abuse that could be quantitatively or qualitatively material applies to all aspects of an audit engagement, including the compliance audit portion. Thus, if the auditor becomes aware of a situation or transaction relating to major program testing that could constitute abuse, the auditor should extend procedures to determine the potential effect on the financial statements or on the major program.

**Reporting Fraud, Illegal Acts, Violations of Provisions of Contract or Grant Agreements, or Abuse.** In Yellow Book engagements, auditors have the same responsibilities for detecting material misstatements arising from violations of provisions of contracts or grant agreements as they do for detecting those arising from fraud and illegal acts. However, the Yellow Book makes a distinction between the auditor's responsibilities for reporting fraud and illegal acts, and reporting abuse and noncompliance *other than* fraud and illegal acts. Paragraph 5.10 in the Yellow Book states that auditors should report "all instances of fraud and illegal acts unless inconsequential" and "violations of provisions of contracts and grant agreements and abuse that could have a material effect on the financial statements." Paragraph 5.15 in the Yellow Book makes it clear that material violations of the provisions of contracts and grant agreements should be reported as noncompliance. However, the Yellow Book prescribes additional responsibilities for reporting fraud, illegal acts, and abuse under certain circumstances.

The Yellow Book at Paragraph 5.15 indicates auditors should include relevant information in their audit report when they conclude, based on sufficient, appropriate evidence, that (a) fraud and illegal acts with a financial statement effect that is more than inconsequential, (b) violations of provisions of contracts or grant agreements with a material effect on the financial statements or other financial data significant to the audit, or (c) material abuse—has occurred or is likely to have occurred. Footnote 68 to Paragraph 5.15 further states "Whether a particular act is, in fact, illegal may have to await final determination by a court of law or other adjudicative body. Disclosing matters that have led auditors to conclude that an illegal act is likely to have occurred is not a final determination of illegality."

With respect to what to report, the descriptions in Paragraph 5.10 of the Yellow Book for reporting are essentially the same as those included in GAAS except the Yellow Book indicates auditors should report abuse. Paragraph 5.18 provides that in certain instances the auditor should report fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse directly to parties other than the audited entity. Paragraphs 5.18 through 5.20 describe these instances as follows:

- The audited entity may be required by law or regulation to report certain fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse to specified external parties such as a federal inspector general or a state attorney general. In these instances, when the auditor has communicated his or her findings to the audited entity and the audited entity fails to make the required report to the external party, then the auditors should communicate such an awareness to those charged with governance of the audited entity. If the audited entity does not make the required report within a reasonable period of time

(the Yellow Book uses the phrase “as soon as practical” after the auditors’ communication with those charged with governance), the auditor should report the findings directly to the external party specified in the law or regulation. (Paragraph 5.18a)

- When fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse is likely to have a material effect on the financial statements and involves awards received directly or indirectly from a government agency, auditors may have a duty to report directly if management fails to take remedial steps. Auditors should first report management’s failure to take timely and appropriate action to those charged with governance of the audited entity. Then, if the audited entity does not take timely and appropriate steps as soon as practicable, the auditors should report the entity’s failure to take timely and appropriate steps directly to the funding agency. (Paragraph 5.18b)
- The reporting described above is in addition to any legal requirements to report such information directly to parties outside the entity. Auditors should comply with these requirements even if they have resigned or been dismissed before completing the audit. (Paragraph 5.19)
- The auditor should obtain sufficient, appropriate evidence (such as confirmation from an outside source) that the findings have, in fact, been properly reported by the audited entity. If such evidence cannot be obtained, the auditor should report the findings as discussed above. (Paragraph 5.20)

**Other Considerations.** As indicated in Paragraph 4.29 of the Yellow Book, auditors should exercise professional judgment in pursuing indications of possible abuse (as well as possible fraud, illegal acts, and violations of provisions of contracts or grant agreements) so that they do not interfere with potential investigations, legal proceedings, or both.

Fraud, illegal acts, and violations of provisions of contracts or grant agreements should be reported as noncompliance in the appropriate Single Audit reports required by OMB Circular A-133.

**Presentation of Findings.** The Yellow Book, at Paragraph 5.22, indicates auditors should report their findings in perspective by describing the extent of their work and the nature and extent of the matters being reported. When applicable, auditors should relate the findings to the population or the number of cases identified and quantify the results using dollar values or other measures. The presentation of the findings should include (a) the criteria against which performance is measured, (b) the condition that exists, (c) the cause of or reason for the condition, and (d) the effect or potential effect of the condition.

## Responsibilities Under the HUD Audit Guide

The HUD audit guide goes beyond GAAS and the Yellow Book in requiring that the auditor audit the HUD-assisted entity’s compliance with laws and regulations that could have a material effect *on each major HUD program*. The auditor must do enough testing of major programs to provide a sufficient basis for expressing an opinion on compliance related to major programs. “Material effect” means that noncompliance with HUD laws and regulations could affect the allowability of major program expenditures or the entity’s eligibility to receive HUD financial assistance.

**Responsibility Related to Major Programs.** The specific requirements set forth in the *Consolidated Audit Guide for Audits of HUD Programs*, if not complied with, could have a material effect on a major HUD program and, therefore, need to be tested.

The auditor is required to select transactions charged to *each* major program and test them for compliance with HUD laws and regulations to support the auditor’s opinion on compliance. When determining the extent of tests, the auditor should assess audit risk and materiality in relation to each major program being tested. Materiality should not be measured in relation to a combined total for all major programs. The assessed level of materiality and size of the population is critical in determining the scope of the auditor’s work and evaluating the results of audit procedures.

**Responsibility Related to Nonmajor Programs.** The auditor is required to test controls over nonmajor programs. Except for the required Fair Housing and Non-Discrimination testing described below, the HUD audit guide does

not give guidance to for-profit entities on the required compliance testing for nonmajor program transactions. However, Paragraph 1-3 of the HUD audit guide states that auditors of project owners with only nonmajor programs must still test and report on the project owner's compliance with the specific requirements.

**Responsibility Related to Fair Housing and Non-Discrimination Requirements.** The HUD audit guide requires the auditor to test the for-profit project owner's compliance with the "Fair Housing and Non-Discrimination" requirements regardless of whether the HUD program is major or nonmajor. The HUD audit guide does not specify the extent of testing required. Instead, the auditor uses professional judgment to determine the extent of the tests of compliance by considering several factors, including the results of tests of controls used to administer the applicant selection process. If Fair Housing and Non-Discrimination only applies to nonmajor programs, the auditor is not required to issue an *opinion* on compliance, but only to *report* on compliance with the "Fair Housing and Non-Discrimination" requirements.

When testing compliance with the "Fair Housing and Non-Discrimination" requirements, the auditor will find that some of the requirements are tested by inquiry, observation, and inspection.

### Tests of Compliance versus Other Audit Tests

The term *tests of compliance* refers to audit procedures to obtain sufficient, appropriate evidence about a client's compliance with applicable laws and regulations and other contractual requirements of HUD. Synonymous terms are "tests of compliance with laws and regulations" or "tests of compliance with requirements."

Tests of compliance are *substantive procedures* and are usually procedures of details as opposed to analytical procedures. A variety of audit procedures may be used in making tests of compliance including inquiry, observation, inspection of documents, and confirmation.

Tests of compliance should not be confused with the old term for certain tests of controls, i.e., compliance tests of control procedures. SAS No. 55 on internal control, in effect, removes the concept of compliance tests of control procedures from AICPA literature. All references to tests of compliance or compliance tests in this lesson are concerned with substantiating a client's compliance with laws, regulations, or other funding source contractual requirements.

### Transaction-related versus Program-related Requirements

Laws, regulations, and other contractual requirements may be either transaction-related or program-related. The distinction between those types of requirements is an important one for understanding compliance aspects of an audit.

**Transaction-related Requirements.** A transaction-related requirement applies only to individual transactions. The auditor determines whether the transaction is "allowable," that is, whether the types of goods or services that the entity purchased are allowable under HUD regulations.

Noncompliance with a transaction-related requirement may result in a disallowed cost. It is up to HUD to determine whether, in fact, a cost is disallowed. The results of the auditor's tests of compliance of a transaction are questioned costs. A questioned cost is an amount spent by a recipient of HUD funds that may not be in compliance with requirements set forth in the regulatory agreement, statutes, or regulations governing allowability. A questioned cost may result in HUD's requiring that funds already expended be refunded.

Because a questioned cost may have to be refunded to HUD, noncompliance with transaction-related requirements may have a material effect on the financial statements. Materiality is evaluated by the dollar amount of the questioned costs in relation to important financial statement totals or subtotals. The aggregate amount of financial assistance received by the entity establishes an upper limit on the materiality of questioned costs. Thus, an important consideration in planning compliance tests of transaction-related requirements is the materiality of the expenses to HUD programs and the number of items in the population being sampled. Another important consideration is the auditor's assessment of the risk of noncompliance. Together those considerations determine the auditor's assessment of the risk of material misstatement of the financial statements resulting from noncompliance with transaction-related requirements.



The auditor's approach to tests of compliance with transaction-related requirements always involves selection of individual transactions and inspection of supporting documentation. The tests may involve use of audit sampling. The extent of testing depends in part on whether the program is a major or nonmajor program.

In an audit in accordance with GAAS or *Government Auditing Standards*, the auditor needs to test for the allowability of costs only when noncompliance could be material to the financial statements. However, in an audit in accordance with the *Consolidated Audit Guide for Audits of HUD Programs*, the auditor needs to test compliance (allowability) of charges for major programs.

**Program-related Requirements.** A program-related requirement involves an overall aspect of a HUD program rather than individual recorded transactions. In HUD engagements, program-related requirements include the following types of requirements:

- *Reporting*—requirements that specify the reports a project owner must file and additional requirements that apply to those reports.
- *Other General Matters*—requirements that identify certain particular laws or regulations that must be complied with as part of the regulatory agreement or housing assistance payments contract.

The materiality of program-related requirements to the financial statements depends on the particular requirements. The *reporting requirements* must usually be met for the entity to be entitled to the financial assistance; for example, the requirement to submit certifications of tenant incomes or HAP vouchers. Thus, in those cases, if the related assistance is material, noncompliance could be material. *Other program-related requirements* are usually not directly material to the financial statements. The auditor would need to test compliance with the program-related requirements when the regulatory agreement specifically requires such audit procedures and when the program has been identified as a major program. The one exception is that the Fair Housing and Non-Discrimination compliance requirements must be tested for both major and nonmajor programs.

### Relationship of Compliance Tests to Internal Controls

HUD regulations are usually concerned with all of a project owner's controls relating to the receipt of HUD funds, disbursements of project assets by the project owner, and administration of HUD programs. Thus, they are concerned with both the design and the operating effectiveness of all relevant controls used in ensuring compliance with laws, regulations, and contractual requirements of the regulatory agreement.

The controls relevant to ensuring compliance with HUD requirements are important factors in assessing the risk of noncompliance and designing effective compliance tests. Therefore, HUD audit guide requires the auditor to perform tests of controls over both major and nonmajor HUD programs. The requirement to test internal control is not relative to any efficiency decision by the auditor. A significant implication of the concern with internal control in compliance auditing is that the auditor should give consideration to the possibility of assessing control risk at less than high for transaction streams associated with HUD requirements. That is usually efficient because HUD agreements require a more detailed understanding of controls for ensuring compliance with laws, regulations, and contract terms than would ordinarily be necessary in an audit of financial statements. The extent of the understanding and the need to apply tests of controls are typically more extensive than would be necessary when control risk is assessed at high.

Another significant consideration in determining which controls to test in a compliance audit is the importance of identifying transaction streams (i.e., transaction types within transaction classes). In other words, within the class of expenditure transactions, the auditor will be particularly concerned with transaction streams related to HUD programs. An effective approach is usually to review the HUD agreement, identify all transaction streams associated with the agreement, and then identify relevant controls for those transaction streams.

### Relating Compliance Audit Procedures to Financial Audit Procedures

The components of a HUD audit include an audit of the financial statements and an audit of the project owner's compliance with HUD requirements. The ideal approach to the HUD audit is to perform both parts of the audit simultaneously so that efficiency can be maximized when testing transactions and/or controls.

The auditor must consider the effects on the financial statement audit of any findings or questioned costs identified in the compliance part of the HUD audit. Likewise, the compliance audit of the HUD program should be able to take advantage of the results of audit procedures performed in auditing the basic financial statements of the entity. For example, if the auditor determines that testing controls to reduce the assessed level of control risk over a particular audit area is appropriate for the financial statement audit, the auditor may be able to reduce substantive tests of compliance in the compliance part of the audit for those areas in which controls have been determined to be effective. However, care should be exercised when attempting to use the results of audit tests in the financial part of the HUD audit to reduce testing in the compliance part of the audit because of the differences in the audit objectives of the two parts. The auditor may also be able to reduce substantive tests of compliance if the tests of controls required by the HUD audit indicate that controls are effective and the control risk assessment can be reduced below high. Consideration should also be given to the HUD audit guide's requirements when sampling is used to test compliance requirements.

## SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. A for-profit entity is considered a major HUD program and requires an audit when it receives assistance in excess of what dollar amount in any given year under a HUD program?
  - a. \$150,000.
  - b. \$250,000.
  - c. \$300,000.
  - d. \$500,000.
2. The HUD compliance environment includes "Program Fraud Alerts" in an attempt to "partner" CPAs with HUD in detecting noncompliance. If equity skimming of HUD project funds occurs "in a period during which the mortgage note is in default or the project is in a nonsurplus cash position, as defined by the regulatory agreement", such misuse of project funds is a felony and can be punished as follows:
  - a. Up to 10 years imprisonment and fines up to \$1M.
  - b. Up to 5 years imprisonment and fines up to \$750,000.
  - c. Up to 5 years imprisonment and fines up to \$500,000.
  - d. Up to 5 years imprisonment and fines up to \$250,000.
3. If a HUD project is in a nonsurplus cash position or is in default, which of the following would be considered a legal action on the part of the project?
  - a. Payment of construction or rehabilitation costs from mortgage proceeds.
  - b. Management fees being shared with the project owner.
  - c. Advances made to the project by the management agent being repaid using nonsurplus funds.
  - d. Lending of funds to affiliates, partners, or owners.
4. There are several exceptions to the minimum monthly Section 8 rent requirements for residents of multifamily housing projects based on hardship conditions. Which of the following is **not** one of those hardship conditions?
  - a. The family has lost private transportation.
  - b. Loss of employment has reduced family income.
  - c. The minimum rent would cause the family to be evicted.
  - d. The family has lost eligibility.
5. Which of the following is accurate regarding a project owner's desire to house over-income police officers or other security personnel?
  - a. The project owner cannot house any individual whose income is more than the amount allowable by HUD.
  - b. Any over-income security personnel must have income that is a maximum of 120% of allowable income.

- c. The project owner must apply to the field office of HUD to obtain authorization to house over-income police officers or other security personnel.
  - d. The project owner may, at their discretion, elect to house police officers or other security personnel regardless of income.
6. Which of the following statements regarding advance notice to tenants by project owners of HUD multifamily housing programs is accurate?
- a. Project owners must provide tenants a 90-day notice of any increase in rent due to the expiration or termination of a contract.
  - b. Certain parties must be given at least 180 days written notice by project owners of their intent to prepay the mortgage.
  - c. Project owners must provide tenants at least 270 days written notification of the termination of a contract.
  - d. Project owners must provide tenants at least one-year written notification of the expiration of a contract.
7. Although not mandated federal preference requirements, project owners may elect to use a number of preferences when selecting candidates for HUD housing programs. Which of the following is one of those preferences?
- a. Residents of the preferred area that do not have prior HUD approval.
  - b. Households without an employed member.
  - c. Victims of domestic violence.
  - d. Single person age 60 or older that is homeless.
8. Castleberry Heights is a for-profit HUD assisted entity that participates in Section 8 rental assistance programs as well as the Green Retrofit Program. What steps should Castleberry Heights and their auditor take to ensure all HUD audit requirements are met?
- i. Determine whether the Green Retrofit award is a major HUD program.
  - ii. Determine if an auditor's opinion on compliance is required.
  - iii. Determine if the *Government Auditing Standards* apply.
  - iv. Determine if the requirements of the HUD audit guide apply.
- a. I only.
  - b. I and ii.
  - c. ii, iii and iv.
  - d. I, ii, iii and iv.
9. Bill is an auditor who has been engaged to perform a HUD compliance audit. Which of the following government pronouncements will define Bill's responsibility concerning errors, fraud, and illegal acts and their possible effect on the financial statements?
- a. SAS No. 54.

- b. SAS No. 55.
  - c. SAS No. 74.
  - d. *Consolidated Audit Guide for Audits of HUD Programs*.
10. The HUD audit guide addresses the auditor's responsibilities related to Fair Housing and Non-Discrimination requirements under HUD programs. Which of the following statements applies regarding those requirements?
- a. Determining whether the HUD program is major or nonmajor is necessary in deciding whether testing the for-profit project owner's compliance with requirements is required.
  - b. The HUD audit guide specifies the extent of testing the auditor is required to conduct.
  - c. The auditor should always issue an *opinion* on compliance.
  - d. For nonmajor programs, the auditor only needs to *report* on compliance.
11. Which of the following is considered a *transaction-related requirement*?
- a. A requirement that specifies which reports must be filed by a project owner as well as additional requirements applicable to those reports.
  - b. A requirement that determines whether the types of goods or services the entity purchased under HUD regulations are allowable.
  - c. A requirement that identifies specified laws or regulations that must be adhered to as part of the regulatory agreement or housing assistance payments contract.
12. Which of the following types of costs are results of the auditor's tests of compliance?
- a. Questioned costs.
  - b. Disallowed costs.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. A for-profit entity is considered a major HUD program and requires an audit when it receives assistance in excess of what dollar amount in any given year under a HUD program? **(Page 7)**
  - a. \$150,000. [This answer is incorrect. \$150,000 in annual assistance does not meet the minimum requirement in order for a for-profit entity to be considered a major HUD program.]
  - b. \$250,000. [This answer is incorrect. A for-profit entity can receive assistance of \$250,000 in any year and still not be considered a major HUD program.]
  - c. **\$300,000. [This answer is correct. When a for-profit entity receives assistance in excess of \$300,000 in a year under a HUD program, that program is considered a major HUD program, and is required to express an opinion on compliance with requirements that are applicable to major HUD programs.]**
  - d. \$500,000. [This answer is incorrect. Assistance can be an amount less than \$500,000 in a year and still cause a for-profit entity to be considered a major HUD program.]
2. The HUD compliance environment includes "Program Fraud Alerts" in an attempt to "partner" CPAs with HUD in detecting noncompliance. If equity skimming of HUD project funds occurs "in a period during which the mortgage note is in default or the project is in a nonsurplus cash position, as defined by the regulatory agreement", such misuse of project funds is a felony and can be punished as follows: **(Page 9)**
  - a. Up to 10 years imprisonment. [This answer is incorrect. A conviction for equity skimming of HUD project funds cannot result in imprisonment for a period of time as long as 10 years.]
  - b. Up to 5 years imprisonment and fines up to \$750,000. [This answer is incorrect. Fines cannot be as large as \$750,000 for conviction of equity skimming of HUD project funds.]
  - c. **Up to 5 years imprisonment and fines up to \$500,000. [This answer is correct. The misuse of HUD project funds (such as equity skimming) is a felony and can be punished by imprisonment for a period of up to 5 years and fines up to \$500,000.]**
  - d. Up to 5 years imprisonment and fines up to \$250,000. [This answer is incorrect. Fines can exceed \$250,000 for conviction of equity skimming of HUD project funds.]
3. If a HUD project is in a nonsurplus cash position or is in default, which of the following would be considered a legal action on the part of the project? **(Page 9)**
  - a. **Payment of construction or rehabilitation costs from mortgage proceeds. [This answer is correct. Payment of construction or rehabilitation costs from mortgage proceeds is legal. However, payment of construction or rehabilitation costs from operations could be viewed as equity skimming, and, therefore an illegal action.]**
  - b. Management fees being shared with the project owner. [This answer is incorrect. If the project is in default or is in a nonsurplus cash position, sharing of management fees with the project owner could constitute an illegal action known as equity skimming.]
  - c. Advances made to the project by the management agent being repaid using nonsurplus funds. [This answer is incorrect. If a HUD project is in a nonsurplus cash position or is in default, repayment of advances made to the project by the owner or management agent could be construed as an illegal act subject to prosecution.]
  - d. Lending of funds to affiliates, partners, or owners. [This answer is incorrect. Lending funds to affiliates, partners, owners, or the management agent could constitute the misuse of project funds known as equity skimming and result in criminal prosecution.]

4. There are several exceptions to the minimum monthly Section 8 rent requirements for residents of multifamily housing projects based on hardship conditions. Which of the following is **not** one of those hardship conditions? **(Page 10)**
- a. **The family has lost private transportation. [This answer is correct. Loss of private transportation does not qualify a family in a multifamily housing project for an exemption from the minimum monthly Section 8 rent that was established in the Quality Housing and Work Responsibility Act (QHWRA) of 1998.]**
  - b. Loss of employment has reduced family income. [This answer is incorrect. One exemption to the minimum monthly rent requirement is if the family income has decreased due to changes in circumstances such as loss of employment.]
  - c. The minimum rent would cause the family to be evicted. [This answer is incorrect. QHWRA provides an exemption to the minimum monthly Section 8 rent requirement in situations where such requirement would cause the family to be evicted.]
  - d. The family has lost eligibility. [This answer is incorrect. If a family has lost eligibility, or an eligibility determination is pending for a federal, state, or local assistance program, QHWRA provides an exception to the minimum monthly rent requirement for that family.]
5. Which of the following is accurate regarding a project owner's desire to house over-income police officers or other security personnel? **(Page 10)**
- a. The project owner cannot house any individual whose income is more than the amount allowable by HUD. [This answer is incorrect. The project owner can house individuals in law enforcement and security guards with over-income if he or she meets HUD requirements for doing so.]
  - b. Any over-income security personnel must have income that is a maximum of 120% of allowable income. [This answer is incorrect. HUD requirements do not provide for a specific income threshold that qualifies police officers or other security personnel for HUD project housing.]
  - c. **The project owner must apply to the field office of HUD to obtain authorization to house over-income police officers or other security personnel. [This answer is correct. Over-income police officers and other security personnel may be housed in HUD projects so long as the project owners obtain approval from the HUD field office.]**
  - d. The project owner may, at their discretion, elect to house police officers or other security personnel regardless of income. [This answer is incorrect. The project owner does not have the authority on their own to house over-income police officers or other security personnel in HUD projects.]
6. Which of the following statements regarding advance notice to tenants by project owners of HUD multifamily housing programs is accurate? **(Page 10)**
- a. Project owners must provide tenants a 90-day notice of any increase in rent due to the expiration or termination of a contract. [This answer is incorrect. Project owners are not required to provide tenants with a 90-day notice of rent increases that may result from the expiration or termination of a contract.]
  - b. Certain parties must be given at least 180 days written notice by project owners of their intent to prepay the mortgage. [This answer is incorrect. Project owners must give certain parties with at least 150 days, but not more than 270 days, written notice of their intent to prepay the mortgage.]
  - c. Project owners must provide tenants at least 270 days written notification of the termination of a contract. [This answer is incorrect. Project owners must provide tenants with written notification of the termination of a contract. However, the notice period is something other than 270 days.]
  - d. **Project owners must provide tenants at least one-year written notification of the expiration of a contract. [This answer is correct. Project owners must provide tenants and HUD a minimum of one-year's notice of the expiration of a contract.]**



7. Although not mandated federal preference requirements, project owners may elect to use a number of preferences when selecting candidates for HUD housing programs. Which of the following is one of those preferences? **(Page 11)**
- a. Residents of the preferred area that do not have prior HUD approval. [This answer is incorrect. One preference that project owners may elect to use is for residents of the preferred area *with* prior HUD approval.]
  - b. Households without an employed member. [This answer is incorrect. Project owners may apply a preference for households that have an employed member.]
  - c. **Victims of domestic violence. [This answer is correct. One of the preferences that project owners may use is for victims of domestic violence, even though such preference is not federally mandated.]**
  - d. Homeless single persons age 60 or older. [This answer is incorrect. Other project owner nondiscriminatory preferences may include single persons age 62 or older that are homeless or disabled.]
8. Castleberry Heights is a for-profit HUD assisted entity that participates in Section 8 rental assistance programs as well as the Green Retrofit Program. What steps should Castleberry Heights and their auditor take to ensure all HUD audit requirements are met? **(Page 12)**
- i. Determine whether the Green Retrofit award is a major HUD program.
  - ii. Determine is an auditor's opinion on compliance is required.
  - iii. Determine if the *Government Auditing Standards* apply.
  - iv. Determine if the requirements of the HUD audit guide apply.
- a. I only. [This answer is incorrect. Other steps should be completed once the determination is made concerning whether or not the Green Retrofit award is a major HUD program.]
  - b. I and ii. [This answer is incorrect. Once the program is determined to be a major HUD program, the auditor is required to express an opinion; however, this answer does not list all the steps in determining if all HUD audit requirements are met.]
  - c. ii, iii and iv. [This answer is incorrect. The first step, determining if the award is a major HUD program, is omitted from this answer choice.]
  - d. **I, ii, iii and iv. [This answer is correct. All of the steps listed will need to be performed. If Castleberry Heights was not subject to the HUD audit guide in the past, obtaining an award under the Green Retrofit Program will subject Castleberry Heights to the Uniform Financial Reporting Standards, Government Auditing Standards and the HUD audit guide, if the award is a major HUD program.]**
9. Bill is an auditor who has been engaged to perform a HUD compliance audit. Which of the following government pronouncements will define Bill's responsibility concerning errors, fraud, and illegal acts and their possible effect on the financial statements? **(Page 13)**
- a. **SAS No. 54. [This answer is correct. SAS No. 54 (AU 317), *Illegal Acts by Clients*, establishes the auditor's responsibilities concerning laws and regulations related to errors, fraud, and illegal acts and their possible direct and material effect on the determination of financial statement amounts.]**
  - b. SAS No. 55. [This answer is incorrect. SAS No. 55 (AU 319), *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, provide guidance related to consideration of internal control required in all audits and on tests of controls required in certain circumstances of a GAAS audit.]



- c. SAS No. 74. [This answer is incorrect. SAS No. 74 (AU 801), *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*, provides general guidance to auditors engaged to test and report on compliance with laws and regulations under GAAS, federal audit requirements, and GAO *Government Auditing Standards*.]
  - d. *Consolidated Audit Guide for Audits of HUD Programs*. [This answer is incorrect. *Consolidated Audit Guide for Audits of HUD Programs* provides suggested procedures for testing the specific requirements governing each HUD program. In addition, it requires auditors to test controls to evaluate the effectiveness of the design and operation of internal control in preventing or detecting material noncompliance with HUD program requirements.]
10. The HUD audit guide addresses the auditor's responsibilities related to Fair Housing and Non-Discrimination requirements under HUD programs. Which of the following statements applies regarding those requirements? **(Page 18)**
- a. Determining whether the HUD program is major or nonmajor is necessary in deciding whether testing the for-profit project owner's compliance with requirements is required. [This answer is incorrect. Auditors are required to test the for-profit project owner's compliance with requirements regardless of whether the HUD program is major or nonmajor.]
  - b. The HUD audit guide specifies the extent of testing the auditor is required to conduct. [This answer is incorrect. The HUD audit guide does not specify to what extent testing is required.]
  - c. The auditor should always issue an *opinion* on compliance. [This answer is incorrect. In cases where Fair Housing and Non-Discrimination only applies to nonmajor programs, an auditor's *opinion* regarding compliance is not required.]
  - d. **For nonmajor programs, the auditor only needs to report on compliance. [This answer is correct. When Fair Housing and Non-Discrimination only applies to nonmajor programs, the auditor need only report on compliance with those requirements.]**
11. Which of the following is considered a *transaction-related requirement*? **(Page 18)**
- a. A requirement that specifies which reports must be filed by a project owner as well as additional requirements applicable to those reports. [This answer is incorrect. A requirement that specifies reports that must be filed by a project owner as well as additional requirements applicable to those reports is considered a *program-related requirement*.]
  - b. **A requirement that determines whether the types of goods or services the entity purchased under HUD regulations are allowable. [This answer is correct. A transaction-related requirement applies only to individual transactions. The auditor determines whether the types of goods or services purchased by the entity are allowable under HUD regulations.]**
  - c. A requirement that identifies specified laws or regulations that must be adhered to as part of the regulatory agreement or housing assistance payments contract. [This answer is incorrect. A requirement that identifies specified laws or regulations that must be adhered to as part of the regulatory agreement or housing assistance payments contract is considered a *program-related requirement*.]
12. Which of the following types of costs are results of the auditor's tests of compliance? **(Page 18)**
- a. **Questioned costs. [This answer is correct. Questioned costs are amounts spent by a recipient of HUD funds that may not be in compliance with requirements set forth in the regulatory agreement, statutes, or regulations governing allowability. Essentially, the auditor is questioning the compliance of the transaction.]**
  - b. Disallowed costs. [This answer is incorrect. Noncompliance with a transaction-related requirement may result in a disallowed cost. The determination as to whether costs are disallowed is made by HUD. A questioned cost may lead to a disallowed cost.]

## IDENTIFYING COMPLIANCE REQUIREMENTS APPLICABLE TO HUD-ASSISTED FOR-PROFIT ENTITIES

The purpose of this section is to assist auditors in identifying compliance requirements applicable to HUD-assisted for-profit entities. Sources of information include the HUD audit guide, statutes and regulations published in the *Code of Federal Regulations*, contracts and agreements (such as the regulatory agreement and HAP contract), HUD handbooks, and housing notices.

### ***Consolidated Audit Guide for Audits of HUD Programs***

Chapter 3 of the HUD audit guide identifies compliance requirements applicable to for-profit entities that receive assistance under a HUD multifamily housing program.

Although the HUD audit guide identifies compliance requirements, it is a summary. Auditors will *always* need to refer to the project-specific contracts and agreements governing the assistance (such as the regulatory agreement and HAP contract and, in most cases, to the specific statutes and regulations cited in the lesson.

### **Enabling Statutes, Appropriations Acts, and Implementing Regulations**

Every HUD program derives its authority from specific federal legislation enacted by Congress. Appropriations acts enacted separately—often years after initial authorization—actually fund the various programs. For example, the Section 8 rent subsidy program was authorized under housing statutes passed in 1937, but it was not until 1974 that an appropriations act made funds available under the Section 8 program.

Legislation authorizing housing programs and the related appropriations acts are merely the initial legal steps in activating a new program. HUD issues regulations to implement each program (commonly referred to as “implementing regulations”) and publishes them in the *Code of Federal Regulations*. (The *Code of Federal Regulations* can be found on the Internet.) The nature of the topics addressed in implementing regulations varies from program to program but generally includes requirements that are unique to the program, for example, description of the types of projects that are eligible for assistance under the program, a description of the process the owner must follow to obtain financial assistance under the program, and ongoing reporting requirements.

### **Contracts and Agreements**

HUD requirements specific to each HUD project are set forth in agreements signed by the project owner and HUD. From a compliance standpoint, the key documents are the regulatory agreements and, for projects that receive rent subsidies, housing assistance payments contracts. Exhibit 1-1 describes the contents of those documents in greater detail.

#### **Exhibit 1-1**

#### **Regulatory Agreements and HAP Contracts**

##### ***Regulatory Agreement***

The contents of the regulatory agreement vary depending on the type of project but generally address the following areas:

- Owner's administrative duties and bookkeeping responsibilities.
- Owner's duty to maintain security deposit accounts, reserve for replacement funds, and residual receipts.
- Owner's right to make additions to the property.
- In the case of rent subsidized projects, tenant application, eligibility, and income certification procedures to be followed by the owner.

- No discrimination against families with children.
- No substitution of any general partner or management agent without HUD approval.
- No sale or conveyance of property without HUD approval.
- No distributions, except to the extent of surplus cash, and only under specific conditions.
- Prohibition against owner charging initial applicants more than one month's rent plus a security deposit.
- Project owner's duty to maintain property in good repair and condition.
- Records maintenance requirement and 90-day filing requirement for annual audit.
- Requirement to deposit project receipts in a federally insured financial institution.
- Agreement to comply with civil rights statutes.

#### *Housing Assistance Payments Contract (HAP contract)*

Project owners that receive rent subsidies sign Housing Assistance Payments Contracts (HAP contracts) with HUD. The HAP Contract generally includes the following:

- Agreement to market units in accordance with the Affirmative Fair Housing Marketing Plan and the regulations relating to fair housing advertising.
- Agreement to process applications and admit tenants only in accordance with HUD requirements.
- Agreement to provide decent, safe, and sanitary housing.
- Agreement to maintain an appropriate level of flood insurance.
- Agreement to comply with the requirements of the Clean Air Act and the Federal Water Pollution Control Act, if applicable.
- Agreement to abide by nondiscrimination requirements, including Section 504 of the Rehabilitation Act of 1973 and the Age Discrimination Act of 1975.
- Procedures for the owner's billing HUD for rent subsidies.
- Rules governing payments of rent subsidies to project owners.
- Number of units that HUD agrees to assist.
- Procedures for adjusting rents over the term of the HAP contract.
- Rules for paying owners for vacant units.

\* \* \*

Other contracts and agreements may have compliance significance depending on the type of project, for example, an owner of a Section 811 capital advance project for the disabled signs a capital advance agreement with HUD.

#### **HUD Handbooks and Interim Notices**

HUD has been prolific in developing HUD handbooks, which describe the requirements faced by owners and agents in day-to-day project operations. Handbooks of greatest compliance significance are the following:

- HUD HB 4350.3 REV-1, *Occupancy Requirements of Subsidized Multifamily Housing Programs*. This handbook provides extensive coverage of leasing and occupancy requirements for rent subsidized

projects. Coverage includes screening applicants for housing, eligibility requirements, tenant certification, leasing and security deposits, recertification of tenant income, termination of tenancy, and billing HUD for assistance payments.

- HUD HB 4370.2 REV-1, *Financial Operations and Accounting Procedures for Insured Multifamily Projects*. This handbook contains procedures for depositing cash receipts and repaying owner advances.
- HUD HB 4350.1 REV-1, *Multifamily Asset Management and Project Servicing*. This handbook includes requirements for requesting withdrawals from the reserve fund for replacements.
- HUD HB 4370.1 REV-2, *Reviewing Annual and Monthly Financial Reports*. Describes the contents of monthly accounting reports required of some projects, for example, "Schedule of Accounts Payable" and "Schedule of Disbursements."
- HUD HB 4355.1 REV-1, *Flexible Subsidy*. This handbook includes procedures for requesting funds under HUD's flexible subsidy program.
- HUD HB 4381.5, REV-2, *The Management Agent Handbook*. This handbook provides guidance regarding most aspects of HUD's relationship and interaction with owners and management agents of HUD-insured and HUD-assisted properties.
- HUD HB 4600.1 REV-1, *Section 232 Mortgage Insurance for Residential Care Facilities*. This handbook provides administrative and underwriting procedures for program participants and HUD staff for implementation of the Section 232 Mortgage Insurance Program for Nursing Homes, Intermediate Care Facilities, and Board and Care Homes.
- HUD HB 8025.1 REV-2, *Implementing Affirmative Fair Housing Marketing Requirements*. This handbook provides guidance for the implementation of the Affirmative Fair Housing Marketing Regulations (24 CFR Part 200, Subpart M) and the preparation and implementation of AFHM Plans.

The handbooks represent HUD's interpretation of Congress' and federal regulators' intent and are nonauthoritative in the sense that they lack the authority of laws or regulations that have been exposed for public comment prior to issuance. Nevertheless, a long-standing perception held by many within the HUD organization that the handbooks are authoritative remains undiminished. The handbooks and transmittals of changes or revisions to the handbooks are available at [www.hudclips.org](http://www.hudclips.org).

HUD also issues "housing notices" to address topics of current interest or to provide guidance on a specific program or aspect of a program. H 98-25, *New Multifamily Project Audit Requirements Office of Management and Budget (OMB) Circular A-133 Single Audit Act Amendments of 1996*, has particular compliance significance. This notice addresses the implementation of OMB Circular A-133 to nonprofit entities receiving HUD assistance and can be obtained at HUD's online information and resources repository at [www.hudclips.org](http://www.hudclips.org).

**Update of HUD Handbook 4350.3.** HUD Handbook 4350.3, *Occupancy Requirements of Subsidized Multifamily Housing Programs* describes the occupancy requirements and procedures that apply to HUD-assisted projects. On June 29, 2007, HUD issued Change-2 to HUD Handbook 4350.3 REV-1 to clarify existing guidance, expand certain requirements, and provide additional information. Due to the numerous changes to the text, the handbook was reissued in its entirety. Among the significant changes in the new handbook are:

- Discussion in Chapter 2, "Civil Rights and Nondiscrimination Requirements," regarding improving access to services for persons with Limited English Proficiency (LEP).
- Clarifications in Chapter 3, "Eligibility for Assistance and Occupancy," address:
  - Restrictions on eligibility of students for Section 8 assistance.
  - Instructions for using the DHS Form G845S (which addresses confirmation of alien verification for entitlements).

- Applicability of the elderly preference rules set forth in the Community Development Act of 1992.
- Requirement for written occupancy standards.
- Changes or clarifications in Chapter 4, "Waiting List and Tenant Selection," address:
  - Requirements of the tenant selection plan.
  - Reasonable accommodations for applicants.
  - Notification requirements of applicants denied admission.
  - Disposition of applicant and tenant files.
- Changes to Chapter 5, "Determining Income and Calculating Rent," are primarily technical changes to clarify calculations and items included in income and medical expense calculations.
- Chapter 6, "Lease Requirements and Leasing Activities," clarifies unique rules for certain HUD programs. This chapter also provides guidance about addressing the needs of persons of limited English proficiency.
- Changes to Chapters 7, 8, and 9 are primarily for clarification and organization of the text.

HUD Handbook 4350.3 REV-1 CHG-2 was effective upon issuance, except for certain transition provisions. Many of the compliance requirements discussed later in this lesson refer to HB 4350.3 REV-1 CHG-2. The handbook can be accessed or downloaded at <http://www.hud.gov/offices/adm/hudclips/handbooks/hsggh>.

### Identifying the Requirements of Funding Sources Other Than HUD

Owners of HUD projects may receive assistance from other governmental departments or agencies (federal, state, or local governments). Among the assistance programs commonly associated with HUD-assisted projects are the following:

- Summer Jobs Programs under the U.S. Department of Labor.
- Agriculture Nutrition Programs under the U.S. Department of Agriculture.
- Development grants or loans from state governments.
- Grants or loans from state departments of energy.
- Funding for construction or housing assistance from city governments.

For non-HUD programs, the auditor needs to apply procedures to gain an understanding sufficient to design tests of compliance. The auditor should discuss the compliance requirements with the project owner's chief financial officer. The auditor should then review the grant or loan agreement (or other agreement) and discuss requirements with officials at the governmental agency. For federal programs, the auditor can also refer to the *Code of Federal Regulations* cited in the loan or grant agreement. Becoming familiar with the program requirements may also include reading the guidance in the OMB Catalog of Federal Domestic Assistance (CFDA) and the *OMB Circular A-133 Compliance Supplement*.

The HOME Program (Home Investments Partnership Program) is one example of a federal award program that impacts some HUD-assisted projects. Under this program, the state or local government generally grants or loans "bridge financing" to a nonprofit entity that enters into a contract with a syndicated partnership. However, the HUD audit guide does not address this type of award.

Similarly, many new HUD projects, such as Risk Sharing Programs and Section 223(f) programs, participate in the low-income housing tax credit (LIHTC) program. Tenants in these projects are subject to income determinations

and other conditions for which noncompliance, in theory, could trigger recapture of the credit. While the low-income tax credit does not qualify as a federal award, auditors should at least consider whether compliance procedures should be performed when noncompliance could have a material impact on the financial statements.

## TESTS OF CONTROLS OVER COMPLIANCE WITH HUD PROGRAMS

### Gaining an Understanding of Internal Control and Assessing Control Risk

SAS No. 109 (AU 314), *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement*, requires the auditor to obtain a sufficient understanding of each of the five components of internal control to plan the audit.

The following paragraphs discuss the HUD audit guide's requirement to test the effectiveness of controls over compliance with HUD programs.

### Tests of Controls Pertinent to HUD Programs

The HUD audit guide, paragraph 1-6, states:

. . . the auditor should perform tests of controls to evaluate the effectiveness of the design and operation of internal control in preventing or detecting material noncompliance with the requirements of the HUD-assisted programs.

The HUD audit guide's requirement to test controls applies only to internal controls relevant to HUD programs. It does not apply to activities unrelated to HUD programs. This requirement to test controls is not relative to any efficiency decision by the auditor. It is *required* even if the auditor has excluded the effect on controls from the relevant risk assessment for efficiency reasons for the audit of the financial statements. HUD requires the auditor to test controls relative to assuring compliance with specific compliance requirements. Accordingly, not all controls that may be relevant to the financial statements or the financial reporting system would need to be tested. The auditor should gain an understanding of the relevant compliance requirements and then determine what controls are in place to assure such compliance. When determining which controls to test, the auditor should—

- Gain an understanding of the applicable compliance requirements for each of the HUD programs,
- Determine which compliance requirements have a direct and material effect on the HUD program,
- Determine the applicable controls for those compliance requirements,
- Determine what controls are in place to prevent or detect material noncompliance, and
- Document and plan tests of those controls to support the assessed level of control risk.

Some controls may relate to several HUD programs. For example, controls relating to the payment of invoices are typically tested using a sample. In those instances, it may be possible to design the sample and perform the audit procedures for only one sample that includes all of the HUD programs.

### When to Test Controls

The auditor should perform tests of controls over compliance with HUD programs of for-profit entities regardless of whether the auditor assesses the internal control risk at high in the audit of the financial statements. Furthermore, the effectiveness of the design and operation of controls over compliance must be tested for all programs—major and nonmajor alike. When a HUD entity is owned and/or managed by an entity that owns and/or manages more than one HUD-assisted project, controls generally must be tested at the individual project level, not the owner or management entity level. The HUD audit guide also recognizes that, in some situations, testing controls may not be appropriate.

When the auditor has determined that controls are likely to be ineffective in preventing or detecting noncompliance, it is not necessary to test such controls. At paragraph 1-6, the HUD audit guide notes, however, that an internal



control deficiency should be reported in that case. Auditors should be cautious about not testing any controls because of identified weaknesses. If there are controls that may be functioning, appropriate tests should be made. For example, if the auditor has determined that there is a pervasive weakness such as a lack of segregation of duties, the auditor should not eliminate testing of other controls that may be in place, such as having someone verify eligibility of applicants for Section 8 housing.

The following guidelines have been developed to assist auditors in determining whether testing controls over compliance with HUD programs is appropriate:

- Generally, tests of controls are appropriate in the following situations (both of which are dominant in the industry):
  - Projects managed by a project owner who actively participates in the management of the project.
  - Projects managed by regional management companies or large, local management companies. In those companies, there are usually formal systems of internal accounting and administrative controls, multiple layers of supervision, and documented evidence of review processes.
- Generally, testing controls is not prudent in the following situations:
  - The owner (or management agent) is disdainful of controls and compliance obligations.
  - The owner (or management agent) is a “one person” operation.
  - The owner does not actively participate in management, and the management agent is not control-conscious.

### **Performing Tests of the Operating Effectiveness of Controls**

The HUD audit guide provides no specific guidance on performing tests of the design or operating effectiveness of controls. SAS Nos. 109 (AU 314) and 110 (AU 318), however, make the following points:

- Procedures directed toward evaluating the design of a control ordinarily include inquiries of appropriate entity personnel, inspection of documents and reports, observation of the application of specific controls, and tracing transactions through the information system relevant to financial reporting. Inquiry alone is not sufficient. (AU 314.55)
- Tests of the operating effectiveness of controls are performed only on controls the auditor has determined are suitably designed to prevent or detect a misstatement in a relevant assertion. (AU 318.25)
- Tests of the operating effectiveness of a control are concerned with how the control (whether manual or automated) was applied, the consistency with which it was applied during the audit period, and by whom it was applied (AU 318.27).
- Tests of the operating effectiveness of a control ordinarily include procedures such as inquiries of appropriate personnel; inspection of documents, reports, or electronic files indicating performance of the control; observation of the application of the control; and reperformance of the application of the control (AU 318.26).
- Some of the procedures performed to evaluate the design of controls and determine that they have been implemented may also provide audit evidence about the operating effectiveness of the controls. (AU 318.27)
- Generally, IT processing is inherently consistent. For this reason, procedures performed to determine whether an automated control has been implemented may serve as a test of that control's operating effectiveness. (AU 314.56 and AU 318.27)

- The auditor should perform other audit procedures in combination with inquiry to test the operating effectiveness of controls. (AU 318.29)
- The nature of a control influences the type of audit procedure necessary to obtain evidence about its operating effectiveness. If documentation of the operation of a control exists, the auditor might inspect the documentation. If documentation of the operation does not exist, the auditor might obtain audit evidence about the control's operating effectiveness through inquiry in combination with other audit procedures such as observation or the use of CAATs. (AU 318.30)
- Controls should be tested for either a particular time or throughout the period, depending upon the circumstances. For example, when testing controls over a year-end physical inventory count, the auditor needs audit evidence of the control's operating effectiveness only at that period of time. (AU 318.35)

Auditors of HUD entities should also be alert for evidence of control effectiveness that can be obtained from external sources, such as external program reviews. For example, the Section 8 administrator performs annual reviews of Section 8 projects, in which tenant files and subsidy vouchers are examined, specific units are visited, and the waiting list and tenant selection plans are reviewed. This external evidence can assist the auditor in assessing the effectiveness of the HUD entity's controls. However, evidence gained from testing controls in prior years would not be applicable when conducting the compliance audit under the HUD audit guide because the auditor must obtain sufficient, appropriate evidence about the effectiveness of controls every year.

AU 319.96 cautions the auditor that the audit evidence obtained from some tests of controls, such as observation, pertains only to the point in time at which the auditing procedure was applied and, thus, may be insufficient for evaluating the effectiveness of the design or operation of internal controls for periods not subjected to such tests. SAS No. 110, AU 318.46, requires auditors to design sufficient tests of controls to obtain sufficient appropriate audit evidence that the controls are operating effectively throughout the period of reliance. In doing so, the auditor might consider the following factors:

- The frequency that the control is performed during the period.
- The length of time that the auditor is relying on the control's operating effectiveness.
- The relevance and reliability of the audit evidence to be obtained in supporting whether the control prevents, or detects and corrects, material misstatements at the relevant assertion level.
- The extent to which audit evidence is obtained from tests of other controls related to the relevant assertion.
- The extent to which the auditor plans to rely on the operating effectiveness of the control in the assessment of risk (in order to reduce substantive tests).
- The expected deviation from the control.

### **Multi-purpose Tests**

Generally, the most effective approach is to perform tests of controls simultaneously with tests of compliance with laws and regulations (a dual-purpose test). Additionally, these tests may, in some instances, also serve as a substantive test of one or more account balances (triple purpose test). Audit procedures designed to test compliance with applicable laws and regulations for expenditures charged to major HUD programs will simultaneously test the operating effectiveness of controls designed to ensure compliance with those laws and regulations. In some cases, there is no real distinction between tests of compliance with specific requirements and tests of the operating effectiveness of controls over compliance. For example, the HUD audit guide's suggested audit procedures to test compliance with HUD requirements with respect to residual receipts also test the entity's controls over compliance with those requirements:

- Obtain a copy of the entity's regulatory agreement and any amendments or other HUD business agreements, to identify the entity's requirements for making deposits into the residual receipts fund, and copies of the surplus cash calculations from the end of the prior audit period and semiannual period, as applicable.



- Determine whether the surplus cash calculations were prepared in accordance with the regulatory agreement and other HUD guidance.
- Determine whether the entity deposited all required amounts into the residual receipts account for the period under audit according to the surplus cash calculation(s).

The auditor is required to document the understanding of internal control even if multi-purpose tests are used.

### **Sampling in Tests of Controls**

Audit sampling is not required for test of controls, but it may be used and can be very efficient.

## **AUDITING COMPLIANCE REQUIREMENTS TESTED BY TRANSACTION SAMPLING**

In applying audit procedures to obtain sufficient, appropriate evidence about compliance with laws and regulations in a HUD audit, the number, selection, and testing of transactions is based on the auditor's professional judgment, professional standards, and the guidance in the HUD audit guide. This lesson discusses the HUD audit guide's requirements when sampling is used to test compliance with HUD program requirements.

### **Selecting Transactions to Test**

The HUD audit guide's compliance requirements that are typically tested by transaction sampling are included at Exhibit 1-2. A general recommendation for compliance testing for-profit entities is as follows:

- a. Any transaction tested for any purpose during the audit that relates to a HUD program, major or nonmajor, may also be tested for compliance with laws and regulations applicable to the transaction. For example, suppose the auditor is testing a sample of 60 expenditures for accuracy of account coding and classifications, and 15 of the transactions were charged to a major program and 40 were charged to a nonmajor program. The 55 transactions would also be tested for compliance with applicable laws and regulations. That is, the HUD audit guide's suggested audit procedures relative to the applicable compliance requirement(s) would be performed on the 55 transactions that relate to HUD programs.
- b. In doing this, the auditor may consider the number of transactions charged to the major program that were tested in conjunction with other audit procedures when planning compliance testing. In applying this dual-purpose testing approach, however, the auditor must be aware of the HUD audit guide's requirements for sample selection and minimum sample sizes. When using dual-purpose testing then, the auditor must design the sample selection to be in compliance with the HUD audit guide (discussed further in this lesson) as well as GAAS. For example, in the situation in Item a. above, 15 transactions in the sample tested for account coding and classification were charged to a major program, and, thus, the applicable compliance audit procedures were applied to those items. Assuming the auditor plans to test a sample of 60 transactions charged to the major program for compliance with HUD requirements, the auditor would need to select 45 additional items related to the major program for compliance testing.

### **Exhibit 1-2**

#### **Auditing Compliance Requirements by Using Audit Sampling**

##### ***Compliance Requirements That Typically Are Not Tested Using Audit Sampling***

Compliance requirements that typically are not tested using audit sampling (i.e., nonsampling requirements) include:

- Mortgage Status
- Residual Receipts

- Distributions to Owners
- Equity Skimming
- Unauthorized Change of Ownership/Acquisition of Liabilities
- Unauthorized Loans of Project Funds
- Mark-to-Market Program (M2M)

### ***Compliance Requirements That Typically Lend Themselves to Testing by Audit Sampling***

Compliance requirements that lend themselves to testing by audit sampling typically include those that relate to activities or transactions that can be quantified.

- Federal Financial Reports
- Fair Housing and Non-Discrimination
- Replacement Reserve
- Cash Receipts
- Cash Disbursements
- Tenant Application, Eligibility, and Recertification
- Units Leased to Extremely Low-income Families
- Tenant Security Deposits
- Management Functions
- Excess Income
- Leased Nursing Homes
- Section 236 Decoupling Projects

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### **Group Project-based Sampling**

**Applicable Compliance Areas.** Among the significant new revisions in Chapter 3 of the HUD audit guide released in July 2008 are the provisions that allow the auditor to treat for-profit entities with common ownership and/or management as part of a common population for the purpose of testing certain compliance requirements. If a HUD-assisted for-profit entity is owned and/or managed by an entity that owns and/or manages many HUD-assisted entities, the auditor may use group project-based sampling, as described in the HUD audit guide, to test compliance with the following compliance areas:

- Tenant Application, Eligibility, and Recertification
- Tenant Security Deposit
- Management Functions

This provision does not apply to audits of nonprofit entities performed in accordance with OMB Circular A-133.

**Conditions for Use.** The HUD audit guide, at Paragraph 3-1, states the following conditions must exist in order to use group project-based sampling:

- a. The same system must be used by management for the applicable compliance area for all HUD-assisted entities selected for inclusion in the group project-based sample.

- b. For the entities that are to be included in the population and sample, the compliance area must have the same supervisor for all projects, the procedures followed must be identical, and the test of internal controls over compliance must not have disclosed any internal control weaknesses, for example, significant deficiencies or material weaknesses.
- c. The owner(s) must agree to the group project-based sample method.
- d. The auditor must fully document the above information upon which the determination was made, including the owner's signed agreement.

If the auditor uses group project-based sampling on any or all of the three eligible compliance areas listed above, compliance tests must be performed on each individual entity for all other applicable compliance areas.

A representative from the HUD Office of Inspector General provided some clarifying comments about applying the group project-based sampling method during a webcast sponsored by the AICPA's Governmental Audit Quality Center (GAQC) in November 2008. The "same supervisor" for all projects means the person at the project, regional, or corporate level that is responsible for seeing that a function is accomplished. It does not necessarily mean the direct supervisor of the person who carries out the function. The HUD official also clarified that problems with controls over the compliance requirements in the HUD audit guide are the types of internal control weaknesses that would preclude using group project-based sampling. The auditor initially may be aware of internal control weaknesses from previous audits or from the results of HUD management reviews and conclude group project-based sampling is not appropriate. The auditor also may become aware of internal control weaknesses as a result of testing internal controls over compliance during the audit. Depending on the significance of the weaknesses, the auditor may have to consider whether group project-based sampling is still appropriate.

**Group Project-based Sample Selection.** The HUD audit guide requires that the *greater* of the following number of entities be tested each year as a minimum sample for compliance testing:

- 20 percent of the entities in the population.
- Four HUD-assisted entities.

As a result, each entity in the population will be chosen for compliance testing at least once every five years.

The HUD audit guide, at Paragraph 3-1, provides the following examples to illustrate these requirements:

- *Example 1.* An auditor has 50 projects in the population that are to be audited, and the conditions permit the auditor to use group project-based sampling. The auditor would test 20 percent of the population, or 10 projects, since this amount is greater than four.
- *Example 2.* An auditor has 10 projects in the population that are to be audited, and the conditions permit the auditor to use group project-based sampling. The auditor would test the minimum of four projects since 20 percent of the population would only be two projects.

The auditor may increase the group project-based sample to include specific projects from the population based on his or her risk analysis or for any other reason. However, if a specific project is added for compliance testing, it cannot be counted as a part of the 20 percent or minimum sample size of four for that year. The auditor may also choose to audit any project that is eligible to be part of the group project-based sample on a stand-alone basis. The auditor may wish to do this, for instance, if the risk analysis leads the auditor to conclude there are isolated compliance or internal control problems at a particular project and the auditor wishes to use group project-based sampling for other projects under the same ownership or management.

**Documentation Requirements.** As mentioned above, the HUD audit guide includes documentation requirements as a condition for allowing the auditor to use group project-based sampling. One of the purposes of the documentation is to allow the auditor to ensure that all entities in the population will continue to be audited systematically. In addition, SAS No. 103 (AU 339), *Audit Documentation*, requires auditors to identify in the workpapers the items tested.

**Impact on HUD Reporting Requirements.** Applying group project-based sampling to test some or all of the three eligible compliance requirements for an entity does not change the HUD audit guide's compliance reporting requirements. When reporting on specific requirements applicable to major programs under the provisions of the HUD audit guide, the objective is to express an opinion on whether the entity has complied with applicable laws and regulations that may have a direct and material effect on each HUD program. That is, even when group project-based sampling is used, the auditor's opinion on compliance is provided for each individual project, and the compliance testing must support the opinion for each individual project and not the group as a whole.

Prior to allowing group project-based sampling, HUD expected auditors to test each entity individually, even when managed by a common management agent. By allowing this sampling method, auditors can now view all entities managed by a common management agent as a single population under certain conditions allowing the auditor to spread the sample across the entities being tested in the current year. For example, if the auditor decides to sample 25 tenant files to test the Tenant Application, Eligibility, and Recertification compliance requirement, those 25 tenant files would be allocated to the entities (minimum of four) being tested that year. This provision will provide relief for auditors that previously would have selected a sample of 25 items for each entity managed by a common management agent.

If a condition of noncompliance or internal control weakness that is required to be reported is found during compliance testing, it must be reported in the report on compliance with specific requirements applicable to major HUD programs for each entity in the population. Reference should be made to each of the auditor's reports that contain that type finding. For example, a significant deficiency would be required to be included in the audit reports on compliance with specific requirements applicable to major HUD programs for all of the entities that were grouped for the group project-based population. If an audit finding is required to be reported and dollars are involved, only the dollars belonging to that specific entity should be included in that entity's schedule of findings and questioned costs.

Additionally, the HUD audit guide requires that nonmaterial instances of noncompliance must be reported in writing for each individual entity; either in a management letter or some other written correspondence for each entity in the population. The form and date of that communication must be included in the auditor's report on compliance.

### **Auditing Compliance with Laws and Regulations**

Tests of compliance with laws and regulations are substantive audit procedures. The auditor should consider the results of tests of controls when evaluating control risk (the risk that material noncompliance that could occur in a major program will not be prevented or detected on a timely basis by internal controls) and developing substantive procedures. The control risk assessment is an important factor in determining the extent of compliance tests. In determining the nature of the tests of compliance with requirements governing major programs, the auditor should consider the character of those requirements. If the entity has internal controls designed to ensure compliance with laws and regulations, the auditor may be able to restrict the extent of the substantive tests of compliance with laws and regulations by expecting few, if any, deviations in the sample tested. To do so, the auditor would have to perform tests of the design and operating effectiveness of the controls over compliance with laws and regulations. In a HUD audit, it may be efficient to attempt to reduce the extent of these substantive tests of compliance with laws and regulations because the HUD audit guide requires tests of controls related to compliance anyway. Subject to the minimum sample sizes discussed above, effectiveness of controls is one factor that the auditor considers in deciding the number of transactions to test for compliance.

Best practices indicate that any nonmajor program transaction tested in the audit of the financial statements of a for-profit HUD entity that happens to relate to a federal assistance program should also be tested for compliance with laws and regulations.

**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

13. The *Regulatory Agreement* signed by the project owner and HUD generally addresses which of the following areas?
  - a. Agreement to maintain the proper level of flood insurance.
  - b. Procedures for billing HUD by owner's for rent subsidies.
  - c. Rights of owners to make additions to the property.
  - d. Rules covering payments to project owners of rent subsidies.
14. The *Housing Assistance Payments Contract (HAP contract)* signed by the project owner and HUD generally includes which of the following?
  - a. Owner's bookkeeping responsibilities and administrative duties.
  - b. The total number of units that HUD agrees to assist.
  - c. The duty of project owners to maintain property in good condition and repair.
  - d. No discrimination against families that have children.
15. Stewart is a HUD project owner and wants to know the correct procedures for repaying advances made to him by HUD. Which HUD handbook contains the procedures Stewart needs to know in order to make repayment to HUD?
  - a. HUD HB 4370.2 REV-1.
  - b. HUD HB 4350.3 REV-1.
  - c. HUD HB 4350.1 REV-1.
16. HUD issued Change-2 to HUD Handbook 4350.3 REV-1 in June 2007 to provide additional information, expand some requirements, and clarify existing guidance. If a HUD project owner is seeking clarification to instructions for using the DHS Form G845S, which chapter of Change-2 to that handbook clarifies the guidance being sought?
  - a. Chapter 2.
  - b. Chapter 3.
  - c. Chapter 5.
  - d. Chapter 6.
17. Which of the following statements is accurate regarding the auditor's need to perform tests of controls to determine if an internal control is sufficient to prevent or detect material noncompliance with HUD-assisted program requirements?
  - a. Test of controls applies to internal controls pertinent to HUD programs but not to activities unrelated to those programs.

- b. In cases where the auditor has excluded the effect on controls from the relevant risk assessment for efficiency reasons for audit of financial statements, testing controls is optional.
  - c. All controls that could be relevant to the financial statements or the financial reporting system must be tested to assure compliance with all compliance requirements.
  - d. The requirement to test controls is often times important to efficiency decisions by the auditor.
18. SAS Nos. 109 (AU 314) and 110 (AU 318) indicate which of the following concerning performing tests of the design or operating effectiveness of controls?
- a. Tests of the operating effectiveness of a control ordinarily do not include reperformance of the application of the control.
  - b. Procedures performed to determine whether a manual control has been implemented can also serve as a test of that control's operating effectiveness.
  - c. Procedures performed to evaluate the design of controls and confirm that they have been implemented cannot provide audit evidence concerning the operating effectiveness of the controls.
  - d. Procedures geared toward evaluating the design of a control normally include things such as observation of the application of specific controls and inspection of documents and reports.
19. Auditors of HUD entities can obtain evidence of control effectiveness from which of the following sources?
- a. Evidence from testing controls in prior years.
  - b. External program reviews.
20. Which of the following compliance requirements is generally tested by audit sampling?
- a. Equity skimming.
  - b. Mark-to-Market Program (M2M).
  - c. Leased nursing homes.
21. Of the following compliance requirements, which one typically is tested using a means other than audit sampling?
- a. Distributions to owners.
  - b. Federal financial reports.
  - c. Replacement reserve.
  - d. Cash disbursements.
22. Which of the following statements is accurate regarding the conditions that must exist in order to use group project-based sampling?
- a. Management must use a different system for the applicable compliance area for each HUD-assisted entity that is selected for inclusion in the group project-based sample.
  - b. The compliance area should have different supervisors for each project for the entities that are to be included in the population and sample.

- c. It is required that the owner(s) agree to the use of the group project-based sample method.
  - d. An auditor electing to use group project-based sampling is not required to obtain the owner's signed agreement to being included in a group project-based sample.
23. Paul is an auditor with 30 projects in the population that need to be audited. Based on guidelines established in the HUD audit guide, Paul has determined that conditions permit him to use group project-based sampling. As a result, Paul will need to test how many projects in the population this year as a minimum sample for compliance testing?
- a. Four.
  - b. Five.
  - c. Six.
  - d. Ten.
24. Which of the following pronouncements requires auditors to identify in the workpapers the items tested using group project-based sampling?
- a. HUD Audit Guide.
  - b. OMB Circular A-133.
  - c. SAS No. 39 (AU 350).
  - d. SAS No. 103 (AU 339).



## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

13. The *Regulatory Agreement* signed by the project owner and HUD generally addresses which of the following areas? **(Page 28, Exhibit 1-1)**
  - a. Agreement to maintain the proper level of flood insurance. [This answer is incorrect. An agreement to maintain an appropriate level of flood insurance generally is included in Housing Assistance Payments Contracts (HAP contracts) with HUD.]
  - b. Procedures for billing HUD by owner's for rent subsidies. [This answer is incorrect. HAP contracts generally include procedures for the owners to bill HUD for rent subsidies.]
  - c. **Rights of owners to make additions to the property. [This answer is correct. The rights of owners to make additions to the property generally are addressed in the Regulatory Agreement between the owners and HUD.]**
  - d. Rules covering payments to project owners of rent subsidies. [This answer is incorrect. Rules governing the payment of rent subsidies to project owners generally are covered in HAP contracts.]
14. The *Housing Assistance Payments Contract (HAP contract)* signed by the project owner and HUD generally includes which of the following? **(Page 28, Exhibit 1-1)**
  - a. Owner's bookkeeping responsibilities and administrative duties. [This answer is incorrect. Owner's bookkeeping responsibilities and administrative duties generally are addressed in the Regulatory Agreement between owners and HUD.]
  - b. **The total number of units that HUD agrees to assist. [This answer is correct. One provision generally included in HAP contracts is the number of units that HUD agrees to provide with assistance.]**
  - c. The duty of project owners to maintain property in good condition and repair. [This answer is incorrect. The Regulatory Agreement between HUD and project owners generally includes the project owner's duty to maintain the property in good condition and repair.]
  - d. No discrimination against families that have children. [This answer is incorrect. The Regulatory Agreement generally contains a provision that owners will not discriminate against families with children.]
15. Stewart is a HUD project owner and wants to know the correct procedures for repaying advances made to him by HUD. Which HUD handbook contains the procedures Stewart needs to know in order to make repayment to HUD? **(Page 29)**
  - a. **HUD HB 4370.2 REV-1. [This answer is correct. HUD HB 4370.2 REV-1, *Financial Operations and Accounting Procedures for Insured Multifamily Projects*, is the HUD handbook that contains the procedures for repaying owner advances as well as for depositing cash receipts.]**
  - b. HUD HB 4350.3 REV-1. [This answer is incorrect. HUD HB 4350.3 REV-1, *Occupancy Requirement of Subsidized Multifamily Housing Programs*, provides thorough coverage of leasing and occupancy requirements for rent subsidized projects.]
  - c. HUD HB 4350.1 REV-1. [This answer is incorrect. HUD HB 4350.1 REV-1, *Multifamily Asset Management and Project Servicing*, details the requirements for requesting withdrawals from the reserve fund for replacements.]
16. HUD issued Change-2 to HUD Handbook 4350.3 REV-1 in June 2007 to provide additional information, expand some requirements, and clarify existing guidance. If a HUD project owner is seeking clarification to instructions



for using the DHS Form G845S, which chapter of Change-2 to that handbook clarifies the guidance being sought? **(Page 30)**

- a. Chapter 2. [This answer is incorrect. Chapter 2, "Civil Rights and Nondiscrimination Requirements," includes a discussion concerning improving access to services for persons with Limited English Proficiency (LEP).]
  - b. Chapter 3. [This answer is correct. Chapter 3, "Eligibility for Assistance and Occupancy," addresses a number of issues, one being instructions for using the DHS Form G845S that deals with confirmation of alien verification for entitlements.]**
  - c. Chapter 5. [This answer is incorrect. Chapter 5, "Determining Income and Calculating Rent," includes technical changes to clarify calculations and items included in medical expense and income calculations.]
  - d. Chapter 6. [This answer is incorrect. Chapter 6, "Lease Requirements and Leasing Activities," clarifies rules that are unique to certain HUD programs and also provides guidance to address the needs of persons of limited English proficiency.]
17. Which of the following statements is accurate regarding the auditor's need to perform tests of controls to determine if an internal control is sufficient to prevent or detect material noncompliance with HUD-assisted program requirements? **(Page 32)**
- a. Tests of controls applies to internal controls pertinent to HUD programs but not to activities unrelated to those programs. [This answer is correct. The auditor should test controls to evaluate the effectiveness of the design and operation of internal control. Testing controls in this manner will help the auditor determine if the control is effective in preventing or detecting material noncompliance with the requirements of HUD-assisted programs. The requirement to test controls does not apply to activities unrelated to HUD programs.]**
  - b. In cases where the auditor has excluded the effect on controls from the relevant risk assessment for efficiency reasons for audit of financial statements, testing controls is optional. [This answer is incorrect. Even in cases where the auditor has excluded the effect on controls from the relevant risk assessment for efficiency reasons for auditing financial statements, test of controls is *required*.]
  - c. All controls that could be relevant to the financial statements or the financial reporting system must be tested to assure compliance with all compliance requirements. [This answer is incorrect. The auditor is required by HUD to test only controls that could be relevant to assuring compliance with specific compliance requirements; therefore, not all controls that may be relevant to the financial statements would need to be tested.]
  - d. The requirement to test controls is often times important to efficiency decisions by the auditor. [This answer is incorrect. The requirement to test controls is not connected to any efficiency decision by the auditor.]
18. SAS Nos. 109 (AU 314) and 110 (AU 318) indicate which of the following concerning performing tests of the design or operating effectiveness of controls? **(Page 33)**
- a. Tests of the operating effectiveness of a control ordinarily do not include reperformance of the application of the control. [This answer is incorrect. Tests of the operating effectiveness of a control include procedures such as reperformance of the application of the control, inquiries of appropriate personnel, observation of the application of the control, among other procedures.]
  - b. Procedures performed to determine whether a manual control has been implemented can also serve as a test of that control's operating effectiveness. [This answer is incorrect. Procedures performed to determine whether an *automated* control has been implemented may serve as a test of that control's operating effectiveness due to the fact that, generally, IT processing is consistent by design.]
  - c. Procedures performed to evaluate the design of controls and confirm that they have been implemented cannot provide audit evidence concerning the operating effectiveness of the controls. [This answer is

incorrect. Some procedures performed to evaluate the design of controls and determine that they have been implemented may also provide audit evidence concerning the operating effectiveness of the controls.]

- d. **Procedures geared toward evaluating the design of a control normally include things such as observation of the application of specific controls and inspection of documents and reports. [This answer is correct. SAS Nos. 109 and 110 indicate that procedures concerning evaluating the design of a control ordinarily include a number of things such as inquiries of appropriate entity personnel, observation of the application of specific controls, inspection of documents and reports, and tracing transactions through the information system that is relevant to financial reporting.]**

19. Auditors of HUD entities can obtain evidence of control effectiveness from which of the following sources? **(Page 34)**

- a. Evidence from testing controls in prior years. [This answer is incorrect. Auditors cannot obtain evidence of control effectiveness using evidence from testing controls in prior years when conducting the compliance audit under the HUD audit guide due to the fact that the auditor must obtain sufficient, appropriate evidence about the effectiveness of controls *every year*.]
- b. **External program reviews. [This answer is correct. Auditors can obtain evidence of control effectiveness from external program reviews such as when the Section 8 administrator performs annual reviews of Section 8 projects whereby tenant files and subsidy vouchers are examined, specific units are visited, and the waiting list and tenant selection plans are reviewed.]**

20. Which of the following compliance requirements is generally tested by audit sampling? **(Page 35, Exhibit 1-2)**

- a. Equity skimming. [This answer is incorrect. Equity skimming is a compliance requirement that typically is *not* tested using audit sampling because equity skimming is due to transactions that are inappropriate when the program is in a nonsurplus cash position. This is a financial condition of the program under audit and does not lend itself to audit sampling.]
- b. Mark-to-Market Program (M2M). [This answer is incorrect. The M2M program typically is *not* tested using audit sampling because it is a HUD restructuring program to align HUD rents with those of the surrounding market of unsubsidized housing. The compliance auditor would test to make sure rents are in compliance.]
- c. **Leased nursing homes. [This answer is correct. Leased nursing homes are one example of compliance requirements that typically lend themselves to testing by audit sampling because the activity can be quantified.]**

21. Of the following compliance requirements, which one typically is tested using a means other than audit sampling? **(Page 35, Exhibit 1-2)**

- a. **Distributions to owners. [This answer is correct. One example of compliance requirements that typically are not tested using audit sampling are distributions to owners. Distributions to owners may be considered equity skimming if the program is in a nonsurplus position. The auditor would first determine the status of the program. Such a determination is not made using audit sampling.]**
- b. Federal financial reports. [This answer is incorrect. Federal financial reports typically *are* tested using audit sampling because it is quantifiable.]
- c. Replacement reserve. [This answer is incorrect. Replacement reserve is one example of compliance requirements that typically lend themselves to testing by audit sampling because it is quantifiable.]
- d. Cash disbursements. [This answer is incorrect. Cash disbursements are one of many examples of compliance requirements that typically are tested by audit sampling because it is quantifiable.]

22. Which of the following statements is accurate regarding the conditions that must exist in order to use group project-based sampling? **(Page 36)**

- a. Management must use a different system for the applicable compliance area for each HUD-assisted entity that is selected for inclusion in the group project-based sample. [This answer is incorrect. Management must use the *same* system for the applicable compliance area for all HUD-assisted entities that are chosen for inclusion in the group project-based sample.]
  - b. The compliance area should have different supervisors for each project for the entities that are to be included in the population and sample. [This answer is incorrect. The compliance area must have the *same* supervisor for all projects for the entities that are to be included in the population and sample.]
  - c. **It is required that the owner(s) agree to the use of the group project-based sample method. [This answer is correct. The owner(s) must agree to the group project-based sample method, otherwise it cannot be used.]**
  - d. An auditor electing to use group project-based sampling is not required to obtain the owner's signed agreement to being included in a group project-based sample. [This answer is incorrect. The auditor *must* obtain the owner's signature as well as fully document that the program meets all conditions necessary for group project-based sampling.]
23. Paul is an auditor with 30 projects in the population that need to be audited. Based on guidelines established in the HUD audit guide, Paul has determined that conditions permit him to use group project-based sampling. As a result, Paul will need to test how many projects in the population this year as a minimum sample for compliance testing? **(Page 37)**
- a. Four. [This answer is incorrect. Based on HUD audit guide requirements and the number of projects in the population that need to be audited, Paul must test more than four projects.]
  - b. Five. [This answer is incorrect. Testing five projects does not meet the testing requirement based on the fact that Paul needs to audit 30 projects in the population.]
  - c. **Six. [This answer is correct. The requirements in the HUD audit guide require Paul to audit six projects this year as a minimum sample for compliance testing based on a total of 30 projects that need to be tested.]**
  - d. Ten. [This answer is incorrect. In accordance with guidelines in the HUD audit guide, Paul will not need to audit ten projects under the group project-based sampling since he only needs to audit 30 projects in the population.]
24. Which of the following pronouncements requires auditors to identify in the workpapers the items tested using group project-based sampling? **(Page 37)**
- a. HUD Audit Guide. [This answer is incorrect. Although the HUD audit guide includes documentation requirements that must be met in order for the auditor to use group project-based sampling, it does not require auditors to identify in the workpapers the items that were tested.]
  - b. OMB Circular A-133. [This answer is incorrect. OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* does not address audit documentation required for project-based sampling.]
  - c. SAS No. 39 (AU 350). [This answer is incorrect. SAS No. 39 (AU350), *Audit Sampling*, addresses various aspects of audit sampling, but does not address audit documentation required for project-based sampling.]
  - d. **SAS No. 103 (AU 339). [This answer is correct. SAS No. 103, *Audit Documentation*, specifically requires that auditors identify in the workpapers the items tested.]**



**EXAMINATION FOR CPE CREDIT****Lesson 1 (HUDTG091)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. A project must follow the HUD audit guide if it receives assistance under which of the following programs?
  - a. Section 8 for Single Room Occupancy.
  - b. Section 8 Moderate Rehabilitation Projects.
  - c. Section 8 New Construction Programs.
  - d. Section 8 Existing Housing Programs.
2. The civil penalty for using project funds in a manner that violates the regulatory agreement can be \_\_\_\_\_ of any assets or income of a project that was used in violation of the regulatory agreement plus reasonable audit and attorney fees.
  - a. One and a half times the value.
  - b. Double the value.
  - c. Triple the value.
  - d. Quadruple the value.
3. Other than in the case of certain hardship conditions, the Quality Housing and Work Responsibility Act of 1998 (QHWRA) sets the minimum monthly Section 8 rent for multifamily housing programs at:
  - a. \$75 per family.
  - b. \$50 per family.
  - c. \$25 per family.
  - d. No minimum is stipulated.
4. Under Housing Notice 00-18, project-based Section 8 assistance requires a minimum of what percent of the units becoming available each federal fiscal year to be reserved for eligible applicants with extremely low incomes?
  - a. 40%.
  - b. 35%.
  - c. 30%.
  - d. 25%.
5. With regard to income targeting, other than in the case of very low income families, not more than 15% of the units originally available for occupancy after which of the following dates shall be rented to low-income families?
  - a. September 30, 1980.

- b. March 31, 1981.
  - c. September 30, 1981.
  - d. October 31, 1981.
6. Auditors responsibilities regarding the possibility that abuse may have occurred include all the following **except**:
- a. If auditors determine that a transaction or situation indicates abuse may have occurred, they should assess whether the possible abuse could materially affect financial statement amounts or other financial data.
  - b. If auditors become aware of abuse that may be material to the financial statements and further determine that the abuse represents potential fraud or illegal acts, they are required to provide reasonable assurance of detecting abuse.
  - c. Auditors should take into account both qualitative and quantitative factors when making judgments concerning the materiality of possible abuse and whether extending the audit procedures is warranted.
  - d. If possible abuse could materially affect the financial statement amounts or other financial data, auditors should extend audit procedures as needed to determine whether abuse occurred and its effect on the financial statement amounts or other financial data.
7. Which of the following requires the auditor to audit the HUD-assisted entity's compliance with laws/regulations that could have a material effect *on each major HUD program*?
- a. GAAS.
  - b. The Yellow Book.
  - c. The HUD audit guide.
  - d. OMB Circular A-133.
8. When determining the audit approach, which of the following actions by the auditor may depend upon whether the program being tested is major or nonmajor?
- a. Use of audit sampling.
  - b. Inspection of supporting documentation.
  - c. Selection of individual transactions.
  - d. Do not select this answer choice.
9. The *Regulatory Agreement* signed by the project owner and HUD generally addresses which of the following areas?
- a. The owner's responsibility to maintain reserve for replacement funds.
  - b. Agreement to admit tenants only pursuant to HUD requirements.
  - c. Agreement to rent units pursuant to regulations that address fair housing advertising.
  - d. Rules covering payment to owners for units that are vacant.
10. The *Housing Assistance Payments Contract (HAP contract)* signed by the project owner and HUD generally includes which of the following?

- a. HUD approval prior to any sale or conveyance of property.
  - b. Requirement for maintenance of records.
  - c. Limit distributions only to surplus cash, and only under certain conditions.
  - d. Compliance with requirement of the Clean Air Act, if applicable.
11. Randy is a HUD project owner and needs to know the correct procedures to follow to request funds under HUD's flexible subsidy program. Which of the following HUD handbooks should Randy consult to find the answer to his questions?
- a. HUD HB 8025.1 REV-2.
  - b. HUD HB 4355.1 REV-1.
  - c. HUD HB 4370.1 REV-2.
  - d. HUD HB 4600.1 REV-1.
12. Change-2 to HUD Handbook 4350.3 REV-1 includes a number of changes or clarifications. Which of the following is covered in Chapter 3 of Change-2?
- a. Notifications requirements of applicants that have been denied admission.
  - b. Disposition of files for both tenants and applicants.
  - c. Applicability of elderly preference rules in the Community Development Act of 1992.
  - d. Demonstration of reasonable accommodations for all applicants.
13. In cases where a HUD entity is managed and/or owned by an entity that manages and/or owns more than one HUD-assisted project, controls generally must be tested at:
- a. The individual project level.
  - b. The management entity level.
  - c. The owner level.
  - d. Any level.
14. Generally, tests of controls are appropriate in which of the following situations?
- a. Projects with a management agent who does not favor compliance obligations.
  - b. Projects with an owner not actively participating in management.
  - c. Projects with a management agent who is a "one person" operation.
  - d. Projects managed by regional or large, local management companies.
15. Generally, which of the following is the most effective approach when testing for evidence of control effectiveness?
- a. Perform tests of controls separately from test of compliance with laws and regulations.



- b. Perform tests of controls at the same time as tests of compliance with laws and regulations.
  - c. Do not select this answer choice.
  - d. Do not select this answer choice.
16. Which of the following compliance requirements typically is tested using audit sampling?
- a. Mortgage status.
  - b. Excess income.
  - c. Residual receipts.
  - d. Unauthorized loans of project funds.
17. Which of the following compliance requirements typically is **not** tested using audit sampling?
- a. Tenant security deposits.
  - b. Units leased to extremely low-income families.
  - c. Section 236 decoupling projects.
  - d. Unauthorized change of ownership/acquisition of liabilities.
18. According to the HUD audit guide, the auditor may use group project-based sampling to test compliance with all the following compliance areas **except**:
- a. Cash receipts.
  - b. Management functions.
  - c. Fair housing and non-discrimination.
  - d. Tenant application, eligibility, and recertification.
19. The HUD audit guide requires that four HUD-assisted entities, or \_\_\_\_\_ of the entities in the population, whichever is *greater*, must be tested each year as a minimum sample for compliance testing.
- a. 15%.
  - b. 20%.
  - c. 25%.
  - d. 30%.

# Lesson 2: Specific Compliance Requirements for HUD-Assisted Projects, Audit Sampling in Tests of Controls Over Compliance, and Planning the Extent of Substantive Tests of Compliance

## INTRODUCTION

### Specific Compliance Requirements Applicable to For-Profit Project Owners of HUD-Assisted Projects

The compliance requirements discussed in this section apply to HUD-assisted projects owned by for-profit project owners. Auditors of nonprofit project owners should consult the *OMB Circular A-133 Compliance Supplement* (Compliance Supplement) for applicable compliance requirements.

#### Learning Objectives:

Completion of this lesson will enable you to:

- Summarize compliance requirements for HUD-assisted projects.
- Utilize audit sampling in tests of controls over compliance.

### Specific Compliance Requirements

Chapter 3 of the HUD audit guide contains the specific requirements that might apply to a HUD-assisted project. The following specific compliance requirements are addressed in Chapter 3:

- a. Federal Financial Reports
- b. Fair Housing and Non-Discrimination
- c. Mortgage Status
- d. Replacement Reserve
- e. Residual Receipts
- f. Distributions to Owners
- g. Equity Skimming
- h. Cash Receipts
- i. Cash Disbursements
- j. Tenant Application, Eligibility, and Recertification
- k. Units Leased to Extremely Low-income Families
- l. Tenant Security Deposits
- m. Management Functions
- n. Unauthorized Change of Ownership/Acquisition of Liabilities
- o. Unauthorized Loans of Project Funds

- p. Excess Income
- q. Leased Nursing Homes
- r. Mark-to-Market Program (M2M)
- s. Section 236 Decoupling Projects

The following paragraphs discuss the compliance requirements and suggested audit procedures for testing compliance with those requirements.

### **Federal Financial Reports**

**Compliance Requirement.** The HUD audit guide, at Paragraph 3-5.A.1., states that the compliance requirement for federal financial reports is as follows:

Projects are required to ensure that financial status reports contain reliable financial data and are presented in accordance with the terms of applicable agreements between the project and HUD. The individual agreements contain the specific reporting requirements that the project must follow. HUD will usually require monthly reports whenever annual financial reviews, on-site reviews, or other information indicates that the project is experiencing financial or management difficulties or the owner/agent is suspected of noncompliance (HUD Handbook 4370.1, chapter 3). The type of annual statements can vary by program. HUD Handbooks 4370.2 and 4350.1 provide detailed guidance as to which owners must submit financial statements and the types of statements that are required.

Exhibit 2-1 lists the types of federal financial reports applicable to HUD-assisted entities. The auditor can determine which of those reports apply to a particular entity through discussions with the project owner and management agent, by reading the regulatory agreement, and, for subsidized projects, by reading the HAP contract or similar contracts.

### **Exhibit 2-1**

#### **Types of Federal Financial Reports**

##### *Monthly Accounting Reports*

Monthly accounting reports are required during the initial rent up period and for financially troubled projects. Also, some HUD offices may request that the project owner submit them. Monthly accounting reports include the following:

- Form HUD-93479, "Monthly Report for Establishing Net Income."
- Form HUD-93480, "Schedule of Disbursements."
- Form HUD-93481, "Schedule of Accounts Payable."

##### *"Budget Worksheet" (Form HUD-92547-A)*

The budget worksheet must be submitted by project owners that use a "budget based" approach to applying for a rent increase.

##### *"Quarterly Performance Report" (Form HUD-9824-A)*

The "Quarterly Performance Report" includes "actual vs. budget" operating comparisons for the past quarter and estimated repair and replacement expenditures for the current quarter. [The report is required in

the Flexible Subsidy program and is discussed in HUD Handbook 4355.1, "Flexible Subsidy," Paragraph 6-2(A).]

\* \* \*

Instances of noncompliance that auditors frequently encounter in the area of federal financial reports include the following:

- a. Reports are not filed in a timely manner.
- b. The financial data reported is inconsistent with amounts included in the project owner's underlying records.
- c. The "Monthly Report of Excess Income" (Form HUD-93104) is prepared incorrectly.
- d. HAP vouchers are not adjusted for tenants who have moved in or out when billing HUD for the rent subsidy.

### **Fair Housing and Non-Discrimination**

**Compliance Requirement.** The HUD audit guide, at Paragraph 3-5.B.1., states that the compliance requirement for fair housing and nondiscrimination is as follows:

Owners and management agents are prohibited from discriminatory practices in accepting applications, renting units, and designating units or sections of a project for renting to prohibited bases in accordance with the Fair Housing Act and the provisions of the regulatory agreement.

The entity is required to market the project in accordance with a document called the "Affirmative Fair Housing Marketing Plan (AFHM Plan)". The AFHM Plan is an owner-prepared document that is submitted to and approved by HUD on Form HUD-935.2A. The AFHM Plan describes how groups of persons ordinarily not likely to apply for residency at the project will feel welcome to apply and have the opportunity to rent. In it, the entity describes the methods that will be used to attract all segments of the eligible population, especially those in the housing marketing area that are "least likely to apply without special outreach."

The AFHM Plan is required for most, but not all, HUD-assisted projects. The most common exception is a refinancing that takes place pursuant to Section 223(f) and/or 232/223(f) and is processed via the Multifamily Accelerated Processing Program (MAP). The regulatory agreement for entities refinanced via MAP provides for owner compliance of the Fair Housing Act, but MAP does not specifically require the AFHM Plan. HUD Handbook 4350.3 REV-1 provides guidance about updating the AFHM Plan at Paragraph 4-13 (F). The entity must review the plan at least every five years, and either submit a revised plan to HUD for approval, or document the review and why no change is required.

The entity also is required to select housing applicants in a nondiscriminatory manner, that is, without regard to the applicant's race, color, religion, sex, disability, family status, or national origin. However, when selecting among applicants for housing, certain preferences must apply and others may apply as described in HUD Handbook 4350.3 REV-1, Paragraph 4-6. Preferences do not affect applicant eligibility. It only affects their order on the waiting list. All applicants must be informed of the available preferences and be given a chance to qualify themselves under the preferences.

- *Statutory Preference—Displacement.* Owners of Section 221(d)(4), 221(d)(3) and 221(d) BMIR properties *must* give preference to applicants who have been displaced by government action or a presidentially declared disaster.
- *HUD Regulatory Preferences.* Owners of Section 236 properties *must* give preference to applicants who have been displaced by government action or a presidentially declared disaster. Owners of Section 236 Projects with rental assistance payments are subject to a "ranking" criteria unique to the program as described in Paragraph 4-6B.2.b. of HUD Handbook 4350.3 REV-1.

- *State and Local Preferences.* Entities *may* apply preferences based on state or local laws if they are consistent with HUD and applicable civil rights requirements, and with advance approval by HUD.
- *Owner-adopted Preferences.* Entities may adopt the following additional preferences (some of which require advance approval by HUD):
  - Residency.
  - Working family.
  - Disability.
  - Victims of domestic violence.
  - Single persons groups (such as elderly, displaced, homeless, or disabled).

Change-2 to HB 4530.3 REV-1 added requirements for preventing discrimination affecting Limited English Proficient Persons (LEP). Under these revisions, entities must take reasonable steps to ensure meaningful access to the information and services they provide for persons with LEP. This may include interpreter services and/or written materials translated into other languages. In addition, the owner's responsibility to market projects to those least likely to apply includes marketing to the LEP population in the community.

Entities are permitted to establish and apply written screening criteria to determine whether applicants will be suitable tenants. This screening criteria must be included in the tenant selection plan and must be applied uniformly to all applicants, including live-in aides of applicants. HUD Handbook 4350.3 REV-1, Paragraph 4-7, specifies the screening criteria. The written screening criteria must prohibit the admission of applicants who have engaged in drug-related behavior, are subject a state lifetime sex offender registration program, or have abused alcohol so that it interferes with other residents. HUD has very specific guidelines governing what project owners can do when selecting and rejecting applicants for housing, and what they cannot do. Those guidelines are commonly referred to as "permitted rejection criteria" and "prohibited screening criteria." Under the *permitted rejection criteria*, project owners are not precluded from rejecting applicants for the following reasons (among others):

- Poor credit history.
- Minimum income requirements in the Section 236 and Section 221(d)(3) BMIR with no other assistance.
- Poor rental history.
- Unhealthy housekeeping habits.

Under the *prohibited screening criteria* set forth in Paragraph 4-8 of HUD Handbook 4350.3 REV-1, entities are prohibited from establishing criteria that:

- Is discriminatory.
- Requires medical evaluation or treatment.
- Requires purchase of meals or other services.
- Requires a donation or contribution.
- Inquires about the tenant's disabled status.
- Is prohibited by state or local laws.

The discussion above applies to owners of HUD-assisted projects subject to HUD Handbook 4350.3 REV-1. Owners of HUD-insured projects that are not subject to HUD Handbook 4350.3 REV-1 are still subject to the provisions of the Fair Housing Act and applicable state and local law.

Auditors should also be familiar with the entity's responsibilities toward disabled persons under Section 504 of the Rehabilitation Act of 1973 and the Fair Housing Act (FH Act). According to HUD Handbook 4350.3 REV-1, Paragraphs 2-8 and 2-44, project owners must do the following:

- Make and pay for reasonable structural modifications to units and common areas, unless they create an undue financial and administrative burden on the project owner.
- Operate housing to prevent segregation based on disability (unless authorized by federal statutes or orders and to promote integration).
- Provide auxiliary aids and services that are necessary to communicate with disabled persons.
- Develop a transition plan to ensure structural changes made to meet accessibility requirements.
- Perform a self-evaluation to ensure disability discrimination does not exist.
- Allow tenants with disabilities to use "service animals," for example, guide dogs, if the animal performs necessary assistance.

HUD Handbook 4350.3 REV-1, at Paragraph 2-5(c) discusses the applicability of the "reasonable accommodations" provisions of the Fair Housing Act (the Act) and Section 504 of the Rehabilitation Act of 1973 to owners of HUD-assisted projects. One type of disability discrimination prohibited by the Act is the refusal to make reasonable accommodations in rules, policies, practices, and services when such accommodations may be necessary to afford a person with a disability the equal opportunity to use and enjoy a dwelling. (See 42 USC 3604(f)(3)(B). The Joint Statement of the Department of Housing and Urban Development and the Department of Justice titled "Reasonable Accommodations Under the Fair Housing Act," issued May 17, 2004, provides further explanation and is available at [www.hud.gov/offices/fheo/library/huddojstatement.pdf](http://www.hud.gov/offices/fheo/library/huddojstatement.pdf). In addition, see 24 CFR Part 100 (especially 100.23 and 100.24). Auditors should consider whether or not their clients who own *market-rate* apartments are in compliance with the reasonable accommodations rules.

**Compliance Audit Procedures.** Chapter 3 of the HUD audit guide describes the suggested audit procedures to test compliance with the fair housing and nondiscrimination compliance requirements, beginning with applying audit procedures to the project's HUD-approved AFHM Plan.

The HUD audit guide requires the auditor to report on the entity's compliance with the "Fair Housing and Non-Discrimination" specific compliance requirement regardless of whether the program under which the project owner receives assistance is major or nonmajor.

The audit guidance set forth above is specifically applicable to HUD-assisted entities subject to HUD Handbook 4350.3 REV-1. Project owners who own "market-rate" apartments are *not* subject to the "prescriptive" documentation requirements regarding "move-ins" and "rejected applicants". Accordingly, there is not a comparable "paper trail" subject to audit. Nonetheless, the overarching provisions of the Fair Housing Act still apply to those entities, and auditors should make appropriate inquiry regarding management's knowledge of the relevant Fair Housing laws and regulations and management's system of internal control to assure compliance with those laws and regulations.

## Mortgage Status

**Compliance Requirement.** The HUD audit guide, at Paragraph 3-5.C.1., states that the compliance requirement for mortgage status is as follows:

Owners shall promptly make all payments due under the note and mortgage.

The entity is required to repay loans (or capital advances) in accordance with the loan agreement (or capital advance agreement).

**Compliance Audit Procedures.** Because failure to comply with the following requirements could subject the owner of the HUD-assisted entity to civil and criminal penalties, the auditor generally should determine that:

- a. The owner pays all costs of reasonable and necessary improvements to restore and upgrade the project.
- b. The owner remits to HUD any cash remaining after the improvements have been paid for.
- c. Until the mortgage is current, the project does not make distributions to owners or repay funds advanced by project owners, or repay principal or interest on a project obligation that is junior to the HUD mortgage.

## Replacement Reserve

**Compliance Requirement.** The HUD audit guide, at Paragraph 3-5.D.1., states that the compliance requirement for the replacement reserve is as follows:

Owners, if required, shall establish a reserve for replacement account and make deposits in accordance with HUD requirements, usually the regulatory agreement or business agreement. The reserve for replacement account is usually required to be under the control of the lender. Disbursements from the reserve for replacement fund may be made only after written consent is received from HUD.

Reserve for replacement funds are to be invested in interest-bearing accounts for certain projects. Interest earned on these projects is required to be maintained in the reserve for replacement account. For other projects, HUD strongly encourages owners to invest the reserve for replacement funds. The mortgagee is authorized to invest funds in excess of \$100,000 (the Federal Deposit Insurance Corporation federally insured limit) in approved securities and/or financial institutions as long as it follows the requirements in HUD Handbook 4350.1, paragraph 4-22. Interest on those investments is considered entity funds and may not be disbursed directly to owners or directly to any individual associated with the entity. All interest must flow through the entity accounts and be disclosed in the accounting records.

The owner is responsible for establishing a reserve fund for making necessary repairs and replacements of project property. The replacement reserve must be placed in an interest bearing account if the project is a new construction or substantial rehabilitation project for which the project owners received their notice of funds reservation on or after November 5, 1979, and February 20, 1980, respectively. Though HUD Handbook 4350.1 (Paragraphs 4-20 and 4-23) requires investment of the replacement reserve in only selected projects and encourages it in all others, there are instances in which Real Estate Assessment Center (REAC) is imposing this requirement on entities where it is only encouraged. HUD's strong preference is emphasized in the HUD audit guide's compliance requirement quoted above. HUD Handbook 4350.1, Paragraph 4-22, allows deposits to exceed the federal insurance limits if the entity monitors and documents whether the financial institution has a rating consistent with minimally acceptable ratings established by GNMA and maintains documentation of the ratings for at least three years.

Withdrawals from the reserve fund for replacements must be approved by HUD. HUD Handbook 4350.1, Paragraph 4-9, presents a list of repair and replacement expenditures for which reserve funds can be used.

## Residual Receipts

**Compliance Requirement.** The HUD audit guide, at Paragraph 3-5.E.1., states that the compliance requirement for residual receipts is as follows:

Nonprofit owners and owners of limited distribution projects, Section 202 projects, and Section 811 projects shall establish a residual receipts account and make deposits into the account in accordance with HUD requirements within 90 days after the close of the fiscal year. Disbursements from such fund may be made only after written consent is received from HUD.

Residual receipts consist of the following:

- All "surplus cash" for nonprofit projects.



- Surplus cash in excess of allowable distributions for limited distribution (or limited dividend) entities.
- Collections in excess of a BMIR “contract rent” for Section 221(d)(3) BMIR projects.

If the difference between the monthly operating rent potential and the total tenant payment for *all* units covered by the assistance payment contract is a negative amount, the owner must deposit that amount into the property's residual receipts account on a *monthly* basis.

Profit-motivated entities are not required to maintain residual receipts accounts since all surplus cash of such projects is available for distribution to the partners (or shareholders). In the case of limited distribution entities, a statutory percentage of surplus cash is distributed to partners (or shareholders), and the remainder is deposited into the residual receipts account. In the case of nonprofit entities, all surplus cash is deposited in the residual receipts account. HUD permits certain Section 202 projects to deposit surplus cash in the reserve fund for replacements rather than a residual receipts account.

HUD allows the funds in the residual receipts account and the reserve fund for replacements to be combined for the purpose of purchasing investments. However, the investment principal and interest earned must be returned to the respective accounts upon liquidation of the investment. Residual receipts are held by the mortgagee, except in the case of Sections 202 and 811 projects.

Instances of noncompliance that auditors commonly encounter when performing tests of the residual receipts compliance requirement include the following:

- Entities failing to establish a residual receipts account.
- Entities failing to fund the residual receipts account within 60 days after a Section 202 entity's fiscal year end.

## Distributions to Owners

**Compliance Requirement.** The HUD audit guide, at Paragraph 3-5.F.1., states that the compliance requirement for distributions to owners is as follows:

Owners may not make, receive, and/or retain any distribution of assets or any income of any kind of the project except surplus cash and then only under certain conditions. Surplus cash distributions can only be made as of and after the end of a semiannual or annual fiscal period. Surplus cash distributions cannot be made when the owner is in default under any of the terms of the regulatory agreement, the note, or mortgage. Surplus cash distributions cannot be made out of borrowed funds or if the owner has not complied with all outstanding notices, from HUD or from the mortgagee, for proper maintenance of the project. The allowable distribution for limited distribution owners is further restricted to a percentage of the owner's initial equity investment as described in the regulatory agreement, business agreement or subsequent HUD-approved agreements with the balance of surplus cash required to be deposited in a residual receipts account.

A HUD-assisted entity can pay distributions only in accordance with the terms of its regulatory agreement. The term *distribution* is defined broadly to include many types of payments. It includes:

- Distributions of cash and property to partners (or shareholders).
- Management fees paid to a general partner.
- Payments of unreasonable amounts to related party management agents for services rendered to the project (for example, building maintenance, landscaping, etc.).
- Repayments of owner advances that have not been approved by HUD.

As stated in the compliance requirement for distributions to owners, for-profit HUD entities are only allowed to make surplus cash distributions in accordance with the regulatory agreement and in compliance with any other amendments or associated documents. The term *surplus cash* has a specific definition for a HUD entity, and HUD regulations determine how surplus cash is calculated. Unallowable distributions that are not authorized under the regulatory agreement should be reported as questioned costs in the "Schedule of Findings and Questioned Costs."

## Equity Skimming

**Compliance Requirement.** The HUD audit guide, at Paragraph 3-5.G.1., states that the compliance requirement for equity skimming is as follows:

Equity skimming is the willful misuse of any part of the rent, assets, proceeds, income, or other funds derived from the project covered by the mortgage for any purpose other than to meet actual or necessary expenses of the project. Equity skimming deprives the project of needed funds for repairs, maintenance, and improvements, which contributes to the financial and physical deterioration of the project and the standard of living conditions for the families who depend on the federal government to provide housing. Also, a community where the project is located suffers since the project may become the breeding ground for crime, violence, and drugs. Appendix B to Chapter 3 of the HUD audit guide includes areas disclosed in audit reports in which equity skimming was found in the operations of multifamily projects.

Equity skimming is a new compliance area added in the July 2008 release of the revision to Chapter 3 of the HUD audit guide. The HUD audit guide states that the suggested audit procedures in the guide are designed to disclose equity skimming. The HUD audit guide, at Appendix B to Chapter 3, "Information on Equity Skimming," states that equity skimming is considered to be a fraud. The auditor should be aware of conditions that might indicate equity skimming and consider modifying his or her audit procedures if such conditions are found. If equity skimming is found, the auditor is required to contact the HUD OIG's National Single Audit Coordinator to discuss the auditor's findings and the method used to report them.

Appendix B to Chapter 3 of the HUD audit guide provides a discussion of conditions found by HUD in audits of multifamily programs that are categorized as equity skimming. HUD has provided the following examples of equity skimming to help establish an understanding of equity skimming conditions:

- a. In reviews of cash disbursements and expense accounts, HUD found HUD-assisted funds were used to pay for:
  - (1) Maintenance, administrative, or other expenses of the owner, other programs, or other projects.
  - (2) Debts of the owners or management agent.
  - (3) Loans to owners, principals, or affiliate companies.
  - (4) Mortgages and related expenses not related to the entity.
  - (5) Personal expenses, such as food, clothing, entertainment of spouse and friends, private car expenses, etc., on a project credit card.
  - (6) Individual partner tax preparation or counseling fees (only the preparation of the entity tax return may be paid from operations).
  - (7) Legal fees for handling disputes among partners.
  - (8) Expenses related to arranging the sale of the project or part of the project.
  - (9) Splitting of fees with the management agent or others who provide services to the project. (This can be an illegal kickback whereby a company agrees to refund a portion of its fees to an owner in return for awarding the management or services contract to the company.)

- (10) Theft of funds in which owners or management agents may write checks to themselves or relatives and not try to hide the fact that they have taken the funds.
- (11) Expenses to identity-of-interest companies when:
  - (a) The identity-of-interest company is a conduit for the purchase of materials and supplies and adds on an excessive percentage markup beyond what it needs to cover its own costs.
  - (b) The identity-of-interest company is paid for labor and materials to repair the project but is using on-site maintenance staff and/or materials to do the work.
  - (c) The identity-of-interest company is leasing equipment to the project at rates significantly in excess of those charged on the open market.
  - (d) No work was ever done. The identity-of-interest company may not actually exist, and the bank account may be used to launder funds.
  - (e) The cost for property and liability insurance for the project is in excess of prices charged on the open market or for coverage that is inadequate to protect HUD's interests.
  - (f) The identity-of-interest company provides insurance for the property under a blanket policy covering several HUD and non-HUD properties. The owner or management agent may be prorating an excessive amount to the HUD properties and using the excess reimbursement to offset insurance costs for its non-HUD projects or as a means to divert project funds.
- b. In reviews of cash receipts and revenue accounts, HUD found:
  - (1) Rental units were used for owner activities without HUD approval and no rent was collected for the unit.
  - (2) Income from contracted services such as laundry services, cell tower leases, and cable fees to tenants was retained by the owner.
  - (3) Units were recorded as vacant but were actually rented. The rent received was split between the owner and the management agent.

## Cash Receipts

**Compliance Requirements.** The HUD audit guide, at Paragraph 3-5.H.1., states that the compliance requirement for cash receipts is as follows:

All cash receipts, including those collected by a management agent, must be deposited into an account in the name of the project at an institution in which deposits are federally insured. The project's owner must verify that depositories where it maintains funds in excess of \$100,000 meet certain conditions as outlined in Chapter 2 of HUD Handbook 4370.2.

Although the compliance requirements for cash receipts were removed from previous releases at HUD audit guide, the requirements are still in the underlying handbooks. The cash receipts compliance area was reinstated in the July 2008 release of the revision to Chapter 3 of the HUD audit guide.

Cash receipts must be deposited in the name of the HUD-assisted entity in a *federally insured* account. HUD HB 4370.2 REV-1, Paragraph 2-12, allows deposits to exceed the federal insurance limits if the management agent and project owner monitor and document whether the financial institution has a rating consistent with minimally acceptable ratings established by GNMA and maintain documentation of the ratings for at least three years.

Instances of noncompliance that auditors commonly encounter in this area include the failure to deposit funds in a federally insured account. Funds should only be held by financial institutions with deposits that are insured by the Federal Deposit Insurance Corporation, National Credit Union Association, or another federal government insur-

ance corporation. Auditors should also be alert for conditions that may indicate that equity skimming has occurred when performing the procedures to test the compliance requirements for cash receipts.

## Cash Disbursements

The HUD audit guide, at Paragraph 3-5.I.1., states that the compliance requirement for cash disbursements is as follows:

All disbursements from the regular operating account must be supported by approved invoices, bills, or other supporting documentation. Project funds should only be used to pay for mortgage payments, required deposits to the reserve for replacement fund, reasonable expenses necessary for the operation and maintenance of the project, distributions of surplus cash as permitted, and repayment of owner advances from surplus cash or as authorized by HUD. Disbursements from a centralized account must clearly be traceable to each entity. The actual cash position of each project in this account must be easily identifiable at all times without exception.

As with the compliance requirements for cash receipts discussed above, the compliance requirements for cash disbursements were removed from the previous release of the HUD audit guide, but the requirements are still in the underlying handbooks. The cash disbursements compliance area was reinstated in the July 2008 release of the revision to Chapter 3 of the HUD audit guide.

HUD HB 4370.2 REV-1, Paragraph 2-12, states that cash disbursements must be made only in accordance with:

- a. The "provisions for project expenses." Essentially, the term "provisions for project expenses" means accounts listed in the HUD chart of accounts, and, for entities that are required to submit budgets to HUD, additional accounts approved by HUD as part of the budget process.
- b. Distributions of surplus cash.

Material expenditures not falling into one of those two categories should be reported as questioned costs in the "Schedule of Findings and Questioned Costs." Additionally, expenditures that fall within HUD's broadly defined concept of "unallowable distributions" should be reported as questioned costs regardless of materiality. Auditors should also be alert for conditions that may indicate that equity skimming has occurred when performing the procedures to test the compliance requirements for cash disbursements.

Instances of noncompliance that auditors commonly encounter in this area include the following:

- Paying unreasonable amounts to related party management agents for services rendered to the project (for example, building maintenance, landscaping, etc.). "Unreasonable amounts" means amounts exceeding the amounts ordinarily paid for such services. Such payments are considered "unallowable distributions" and should be reported in the "Schedule of Findings and Questioned Costs" regardless of materiality.
- Repaying owner advances when the project is in a nonsurplus cash position without first obtaining HUD's approval. Such payments should be reported in the "Schedule of Findings and Questioned Costs" regardless of materiality. Repaying owner advances without obtaining HUD's approval can also subject the project owner to criminal and civil penalties.

## Tenant Application, Eligibility, and Recertification

**Compliance Requirement.** The HUD audit guide, at Paragraph 3-5.J.1., states that the compliance requirement for tenant application, eligibility, and recertification is as follows:

Owners who participate in HUD's rent subsidy programs are responsible for accepting applications, maintaining a waiting list, determining eligibility, calculating the tenant's contribution toward rent and utilities, calculating subsidy, and recertifying the tenant annually in accordance with HUD requirements.

The entity is responsible for accepting applications from prospective tenants and certifying that the applicants' income levels qualify them for rental assistance. The entity must also recertify incomes of existing tenants at least annually.

The audit guidance set forth above is specifically applicable to HUD-assisted projects subject to HUD Handbook 4350.3 REV-1. Project owners who own market-rate apartments are not subject to the *prescriptive* documentation requirements regarding tenant application, eligibility and recertification.

The primary sources of information on HUD's requirements in the areas of application, eligibility, and recertification are as follows:

- The Housing Assistance Payments (HAP) Contract.
- HUD HB 4350.3 REV-1 CHG-2, "Occupancy Requirements of Subsidized Multifamily Housing Programs."
- 24 CFR 813, "Definition of Income, Rent, and Reexamination of Family Income for Section 8 and Related Programs."

Because in most cases inherent risk and control risk are low, the compliance test can be done simultaneously with the tests of controls—a dual purpose test. However, if inherent risk and control risk are other than low, the auditor should select a sample of tenant files and compliance test that sample. Inherent risk and control risk might be other than low in the following situations:

- a. In HUD management reviews conducted during the periods covered by the financial statements, the project owner has not received at least "satisfactory" ratings in the area of application, eligibility, and recertification procedures.
- b. Management has a negative, unprofessional attitude toward compliance issues.
- c. Turnover is high among personnel responsible for handling applications and certifying (and recertifying) tenant income.

Inherent risk and control risk might also be other than low if there have been errors identified in prior years in the areas of application, eligibility, and recertification.

### Units Leased to Extremely Low-income Families

**Compliance Requirement.** The HUD audit guide, at Paragraph 3-5.K.1., states that the compliance requirement for units leased to extremely low-income families is as follows:

For each project assisted under a contract for project-based Section 8 assistance, the owner must lease not fewer than 40 percent of the dwelling units to extremely low-income families (HUD Handbook 4350.3, chapter 3, and chapter 4, paragraph 4-5).

The compliance area for units leased to extremely low-income families is a new area added in the July 2008 release of the revision to Chapter 3 of the HUD audit guide. HUD Handbook 4350.3 REV-1, "Occupancy Requirements of Subsidized Multifamily Housing Programs," provides extensive coverage of leasing and occupancy requirements for rent subsidized projects. Coverage includes the requirements for certification of tenant income and billing HUD for assistance payments.

### Tenant Security Deposits

**Compliance Requirement.** The HUD audit guide, at Paragraph 3-5.L.1., states that the compliance requirement for tenant security deposits is as follows:

Funds collected as a security deposit shall be kept in the name of the project, separate and apart from all other funds of the project in a trust account. The amount of this account shall at all times

equal or exceed the aggregate of all outstanding obligations under that account. Funds must not be commingled with funds from any other projects. All disbursements from the security deposit account must be only for refunds to tenants and for payment of expenses incurred by or on behalf of the tenant, not to exceed the amount to which the tenant is entitled. All disbursements must have supporting documentation. In addition, state and local governments may have specific regulations governing the handling of tenant security deposits.

Although the compliance requirements for security deposits were removed from previous releases of the HUD audit guide, the requirements are still in the underlying handbooks. The security deposits compliance area was reinstated in the July 2008 release of the revision to Chapter 3 of the HUD audit guide.

HUD does not require that owners charge applicants a security deposit, but most owners usually do so. Owners of Section 8 new construction and Section 8 substantial rehabilitation projects subject to the "revised Section 8 regulations" are required to maintain security deposits in an interest-bearing account and to have the interest earned on the deposit inure to the benefit of the tenant. A project is subject to the Section 8 revised regulations if it is a new construction or substantial rehabilitation project for which the project owner received their notice of funds reservation on or after November 5, 1979, and February 20, 1980, respectively.

Generally, applicants can be charged only the security deposit plus the first month's rent. (However, owners of subsidized projects for the elderly may also ask the tenant to pay a pet deposit.) Under no circumstances may the owner charge initial applicants the following types of fees:

- Application processing fees.
- Fees for verifying the applicants' income and eligibility for housing.
- "Home visit" fees, that is, fees that the owner charges applicants for inspecting the applicants' current housing before accepting their applications.

Owners must refund the security deposit no later than 30 days after the tenant moves out. (State or local laws may mandate a quicker refund, however.) The owner is required to send departing tenants a letter that lists amounts offset against the security deposit (for items such as unpaid rent or damages) and advises the tenants of their right to meet with the owner and discuss the charges. If a tenant chooses not to meet with the owner, that fact should be documented by the owner. HUD Handbook 4350.3 REV-1, Paragraph 6-18, states that records pertaining to the refund of the departing tenant's security deposit should be retained by the owner for three years.

The security deposit account must be "fully funded," at all times; that is, it should have sufficient funds to make refunds to all tenants. It is a violation of the regulatory agreement to underfund the security deposit account.

## Management Functions

**Compliance Requirement.** The HUD audit guide, at Paragraph 3-5.M.1., states that the compliance requirement for management functions is as follows:

The owner is responsible for complying with all requirements of the regulatory agreement. The owner may perform all management functions or contract with a management agent to provide project management, but the responsibility cannot be delegated to the management agent. The owner or management agent must be approved by HUD and must certify that it will follow HUD's rules and regulations.

The specific requirement, "Management Functions," encompasses several HUD requirements that are not addressed in the other specific requirements. Having been extracted from various HUD handbooks, the "Management Functions" requirements in the HUD audit guide are designed to ensure that the management activities of owner and agent are conducted in accordance with HUD laws and regulations.

Instances of noncompliance that auditors commonly encounter in this area include the following:

- a. Payments for maintenance and other operating expenses exceed the amounts ordinarily paid for such services.



- b. The management agent is reimbursed by the project for expenses that HUD considers to be already included in the management fee (and, thus, are not separately chargeable to the project), including:
- Expenses incurred by the management agent in connection with designing procedures to keep the project in conformity with HUD requirements.
  - Salaries and benefits of the management agent's personnel (except personnel performing "frontline duties," as defined in HUD Handbook 4381.5, Chapter 2).
  - Hiring and supervising personnel.
  - Visiting the project.

The above instances of noncompliance should be reported as questioned costs in the "Schedule of Findings and Questioned Costs." Auditors should also be alert for conditions that may indicate that equity skimming has occurred when performing the procedures to test the compliance requirements for management functions.

The HUD audit guide includes a suggested procedure to determine whether the project is maintained in good repair and condition. If the units are subsidized, the auditor is to determine whether management's procedures ensure that units meet applicable housing quality standards. The auditor should determine if violations of "housing quality standards" were identified in the review and determine if the entity took action to correct them. The housing quality standards are intended to ensure that the owner maintains the housing in a decent, safe, and sanitary condition and cover such areas as building access, security, heating and air conditioning, and utilities. If the entity has not taken corrective action, the auditor should disclose that fact in the compliance report. It should be emphasized this compliance procedure involves determining whether the entity takes corrective action when violations in housing quality standards have been identified; the auditor is not required to make a judgment about whether the project meets those standards.

### **Unauthorized Change of Ownership/Acquisition of Liabilities**

**Compliance Requirement.** The HUD audit guide, at Paragraph 3-5.N.1., states that the compliance requirement for unauthorized change of ownership/acquisition of liabilities is as follows:

Owners shall not, without the prior written consent of HUD, convey, assign, transfer, dispose of, or encumber any of the mortgaged property or permit the conveyance, transfer, or encumbrance of such property.

The HUD regulatory agreement restricts for-profit and limited distribution entities from performing or allowing the conveyance, transfer or encumbrance of the mortgaged property or a beneficial interest in the property without proper consent. HUD must preauthorize such actions in writing to be valid.

**Compliance Audit Procedures.** Suggested audit procedures are comprised of inquiry, confirmation of debt, and review of other audit documentation. The procedures to test for unauthorized transfers of beneficial interests in the mortgaged property, which previously existed as a separate compliance area, were combined with this compliance requirement in the July 2008 release of the revision to Chapter 3 of the HUD audit guide.

### **Unauthorized Loans of Project Funds**

**Compliance Requirement.** The HUD audit guide, at Paragraph 3-5.O.1., states that the compliance requirement for unauthorized loans of project funds is as follows:

Owners shall not, without the prior written consent of HUD, assign, transfer, dispose of, or encumber any personal property of the project, including rents, or pay out any funds except for reasonable operating expenses and necessary repairs.

Similar to the previous compliance requirement, the HUD regulatory agreement restricts for-profit and limited distribution entities from assigning, transferring, disposing of, or encumbering any personal property of the project,



including rents, without proper consent. HUD must preauthorize such actions in writing to be valid. This prohibition excludes disbursements for reasonable operating expenses and necessary repairs paid out of surplus cash.

## **Excess Income**

**Compliance Requirement.** The HUD audit guide, at Paragraph 3-5.P.1., states that the compliance requirement for excess income is as follows:

Owners of properties with mortgages insured under Section 236 of the National Housing Act must submit excess income within 10 days of the end of the month in which it was collected.

Under Section 236 of the National Housing Act, limited distribution entities must not retain excess income without the prior authorization from HUD. Excess income only may be used for purposes authorized by HUD. Excess income is reported using Form HUD-93104, "Monthly Report of Excess Income." HUD Handbook 4350.3, Chapter 9, Paragraph 9-15 and Appendix 13, describes procedures to follow in preparing the excess income report.

## **Leased Nursing Homes**

The HUD audit guide, at Paragraph 3-5.Q.1., states that the compliance requirement for leased nursing homes is as follows:

Owners may enter into lease agreements to operate the facility, in which case the operator will be required to execute a regulatory agreement (HUD 92466-NHL) with HUD before the note is endorsed for insurance. The regulatory agreement requires lease payments to be sufficient to pay all mortgage payments including payments to reserves for taxes, insurance, etc., and payments to the reserve for replacements. If at the end of any fiscal year, payments under the lease have not been sufficient to pay for the above items, the owner and operator/lessee, upon request in writing from HUD, shall renegotiate the amounts due under the lease so that the lease payments shall be sufficient to pay for such items. In addition, the operator/lessee shall provide HUD, within 30 days of request, a financial report, in a form satisfactory to HUD, covering the operations of the mortgaged property and of the project.

The regulatory agreement also requires the operator/lessee to not sublease the project and maintain it in good repair. The owner's regulatory agreement requires the owner to make mortgage payments and reserve deposits. These responsibilities cannot be assigned.

The compliance area for leased nursing homes is a new area added in the July 2008 release of the revision to Chapter 3 of the HUD audit guide. HUD-assisted entities that own nursing homes may enter into leases with other entities that then operate the nursing home. The compliance requirements in this area are designed to determine whether the lease payments are sufficient to allow the entity to service the project's mortgage debt, tax and insurance escrows, and reserve for replacements. Other audit procedures test the lessee's compliance with additional terms of the regulatory agreement such as to properly maintain the project and comply with nondiscrimination laws and regulations.

## **Mark-to-Market Program (M2M)**

The compliance area for the Mark-to-Market Restructuring program is a new area added in the July 2008 release of the revision to Chapter 3 of the HUD audit guide. The Mark-to-Market Restructuring program (M2M) allows an entity to address the situation if its Section 8 rent subsidy contract sets rents at a level that exceeds those charged for unregulated and unsubsidized housing of similar quality and location. The program allows HUD to adjust the contract rents and restructure the entity's mortgage debt. The suggested audit procedures for compliance requirements for entities that have participated in the M2M restructuring program, to the extent they are applicable, must be performed in addition to any other audit procedures that are required to be performed for applicable compliance areas. The compliance requirements are organized into four categories that are designed to test compliance with

important aspects of the M2M program. As described in Paragraph 3-6 of the HUD audit guide, these compliance areas are as follows:

- *Capital Recovery Payments for M2M Projects.* This compliance area is designed to test compliance with the restructuring agreement's terms and conditions governing capital recovery payments to the owner. (This compliance requirement is not applicable to cooperatives.)
- *Incentive Performance Fee for M2M Projects.* This compliance area is designed to test compliance with the restructuring agreement's terms and conditions governing payment of the incentive performance fee.
- *Distribution of Surplus Cash for M2M Projects.* This compliance area is designed to test compliance with the restructuring agreement's terms and conditions governing surplus cash payments.
- *Special Rules for Cooperatives.* Additional compliance requirements for cooperative entities are designed to test compliance with the restructuring agreement's terms and conditions governing escrow deposits, and deposits to and withdrawals from the residual receipts account.

Project owners participating in the Mark-to-Market Restructuring program may be required to fund a rehabilitation escrow and to expend the funds in the escrow consistent with the terms of the escrow. HUD has determined that some project owners are not in compliance with the provisions for expending these funds, and is prepared to take disciplinary action against such owners. Auditors should familiarize themselves with the provisions of depository agreement, and test management's assertions that funds have been expended (a) for qualifying items and (b) within the time frames set forth within the depository agreement.

### Section 236 Decoupling Projects

The HUD audit guide, at Paragraph 3-7.1, states that the compliance requirement for Section 236 decoupling projects is as follows:

As a condition for receiving continued interest reduction payments (IRP) under section 236(e)(2) and section 236(b), the owner agrees to operate the project in accordance with all low-income affordability restrictions for the period identified by the use agreement.

The compliance area for Section 236 decoupling projects is a new area added in the July 2008 release of the revision to Chapter 3 of the HUD audit guide. The Section 236 program offers an interest rate subsidy that lowers the entity's mortgage interest rate. In return, the entity must comply with low-income affordability restrictions. Housing Notice 00-8, *Guidelines for Continuation of Interest Reduction Payments after Refinancing*, allows an entity to continue the interest rate subsidy after refinancing its mortgage debt. The suggested audit procedures test compliance with the program's low-income affordability restrictions.

## REPORTING ILLEGAL ACTS

Paragraph 1-4 of the HUD audit guide states:

If the auditor becomes aware of illegal acts or fraud that have occurred or are likely to have occurred, the auditor should promptly prepare a separate written report and include all questioned costs.

The auditor should send the report on illegal acts to the HUD District Inspector General for Audit. It is strongly recommended that the auditor consult with an attorney on whether a reportable act has occurred and on the wording of the report when a report is used.

Exhibit 2-2 is a summary of criminal and civil penalties for violations of HUD laws and regulations. The exhibit is adopted from Appendix 1 of HUD Handbook 4370.2 REV-1, *Financial Operations and Accounting Procedures for Insured Multifamily Projects* and OIG Program Fraud Alert: *Fraud and Abuse in Multifamily Mortgage Insurance Programs*.



**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

25. Jake is a for-profit HUD project owner and is required to file monthly accounting reports during the initial rent up period. The form Jake should use to report accounts payable is:
- a. Form HUD-9824-A.
  - b. Form HUD-92547-A.
  - c. Form HUD-93480.
  - d. Form HUD-93481.
26. HUD-assisted projects *must* reject which of the following applicants pursuant to written screening criteria in HUD Handbook 4350.3 REV-1, Paragraph 4-7?
- a. Unhealthy housekeeping habits.
  - b. Alcohol abuse that interferes with other residents.
  - c. Failure to meet minimum income requirements.
  - d. Poor rental history.
27. Project owners must do which of the following in accordance with directives in HUD Handbook 4350.3 REV-1, Paragraphs 2-8 and 2-44?
- a. Construct and pay for reasonable structural modifications to units/common areas regardless of the administrative burden on the project owner.
  - b. Operate housing in such a way that tenants are segregated based on their disabilities.
  - c. Contract with an outside source to perform an independent evaluation to determine that disability discrimination exists.
  - d. Allow the use of "service animals" by tenants with disabilities in cases where the animal is trained to perform needed assistance.
28. A project owner is responsible for establishing a reserve fund for the purpose of making repairs and replacements of project property that are necessary. HUD Handbook 4350.1, Paragraph 4-22, states that deposits for such purpose can exceed federal insurance limits so long as the entity monitors and keeps records indicating that the financial institution has a rating in keeping with minimally acceptable ratings established by GNMA and maintains documentation of the ratings for a:
- a. Minimum of two years.
  - b. Minimum of three years.
  - c. Minimum of four years.
29. When the difference between the total tenant payment for all units covered by the assistance payment contract and the monthly operating rent potential is a negative amount, the nonprofit owner must:
- a. Deposit that amount into the property's residual receipts account on a bi-weekly basis.

- b. Deposit that amount into the property's residual receipts account on a monthly basis.
  - c. Deposit that amount into the property's residual receipts account on a quarterly basis.
  - d. Deposit that amount into a separate account from the property's residual receipts account.
30. One instance of noncompliance that auditors frequently encounter when performing tests of the residual receipts compliance requirement is that of entities that fail to fund the residual receipts account within how many days following a Section 202 entity's fiscal year end?
- a. 30 days.
  - b. 60 days.
  - c. 90 days.
31. Which of the following statements concerning distributions to owners of HUD projects is accurate?
- a. Owners may receive distribution of some assets and surplus cash.
  - b. Surplus cash distributions can sometimes be made when the owner is in default under the note.
  - c. Surplus cash distributions can never be made out of borrowed funds.
32. If a project's owner wishes to make deposits of cash receipts at an institution where deposits are federally insured in an amount that exceeds the federal insurance limits, the owner and management agent must monitor and document that the financial institution holds acceptable ratings as determined by GNMA and maintain documentation of the ratings for what period of time?
- a. A minimum of two years.
  - b. A minimum of three years.
  - c. A minimum of four years.
33. Which instance of noncompliance with requirements regarding cash disbursements can subject the project owner to civil and criminal penalties?
- a. Paying unreasonable amounts to related party management agents for services provided to the project for things such as building maintenance.
  - b. Repayment of owner advances in situations where the project is in a nonsurplus cash position prior to receiving HUD's approval.
34. According to the text, there are three primary sources of information on HUD's requirements regarding application, eligibility, and recertification. Which of the following is absent from the list of primary sources of information on HUD's requirements in those three areas?
- a. The Housing Assistance Payments (HAP) Contract.
  - b. The HUD audit guide, at Paragraph 3-5.J.1.
  - c. HUD HB 4350.3 REV-1 CHG-2.
  - d. 24 CFR 813.

35. The compliance requirements cited in the July 2008 release of the revision to Chapter 3 of the HUD audit guide regarding tenant security deposits are accurately reflected in which of the following statements?
- a. Funds collected as a security deposit must be kept in the name of the project and may be combined with other funds of the project.
  - b. Disbursements from the security deposit account should only be for refunds to tenants.
  - c. In addition to HUD's regulations, state and local governments may have specific regulations regarding the handling of tenant security deposits.
36. Brad is the management agent for a HUD project and is reimbursed by the project for visiting the project. Which of the following statements accurately describes the auditor's determination as a result of the management agent being reimbursed for visiting the project?
- a. Such reimbursement of the management agent for visiting the project is normal and customary and, therefore, is separately chargeable to the project.
  - b. Such reimbursement of the management agent for visiting the project is considered by HUD to already be included in the management fee.
37. The operator of a leased nursing home is required to provide HUD with a financial report acceptable to that agency covering the operations of the mortgaged property and of the project within how many days of the request?
- a. 15 days.
  - b. 30 days.
  - c. 45 days.
  - d. 60 days.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

25. Jake is a for-profit HUD project owner and is required to file monthly accounting reports during the initial rent up period. The form Jake should use to report accounts payable is: **(Page 52, Exhibit 2-1)**
  - a. Form HUD-9824-A. [This answer is incorrect. Form HUD-9824-A is the "Quarterly Performance Report" and includes "actual vs. budget" operating comparisons for the past quarter and estimated repair and replacement expenditures for the current quarter. Jake should use this form if he is in the Flexible Subsidy program.]
  - b. Form HUD-92547-A. [This answer is incorrect. Form HUD-92547-A is the "Budget Worksheet" and must be submitted by Jake if he wants to apply for a rent increase using a "budget based" approach.]
  - c. Form HUD-93480. [This answer is incorrect. Form HUD-93480 is the "Schedule of Disbursements" and should be used by Jake to report disbursements.]
  - d. Form HUD-93481. [This answer is correct. Form HUD-93481 is the "Schedule of Accounts Payable" and is the form Jake should use to report his accounts payable to HUD.]**
26. HUD-assisted projects *must* reject which of the following applicants pursuant to written screening criteria in HUD Handbook 4350.3 REV-1, Paragraph 4-7? **(Page 54)**
  - a. Unhealthy residence maintenance habits. [This answer is incorrect. Project owners have the option to reject applicants due to unhealthy residence maintenance habits, but are not required to do so.]
  - b. Alcohol abuse that interferes with other residents. [This answer is correct. HUD Handbook 4350.3 REV-1, Paragraph 4-7, contains written screening criteria prohibiting the admission of applicants in three categories. Those applicants with prior drug-related behaviors, are part of a state lifetime sex offender registration program, and those who have abused alcohol in ways that have interfered with other residents are prohibited from admission to HUD projects.]**
  - c. Failure to meet minimum income requirements. [This answer is incorrect. Failure to meet minimum income requirements is sufficient justification for project owners to reject applicants, but they are not compelled to reject them for this reason.]
  - d. Poor rental record. [This answer is incorrect. Under the permitted rejection criteria, project owners can elect to reject applicants due to a poor rental history, but are not required to reject them by the HUD Handbook.]
27. Project owners must do which of the following in accordance with directives in HUD Handbook 4350.3 REV-1, Paragraphs 2-8 and 2-44? **(Page 55)**
  - a. Construct and pay for reasonable structural modifications to units/common areas regardless of the administrative burden on the project owner. [This answer is incorrect. Project owners must construct and pay for reasonable structural modifications to units and common areas, but only if doing so does not create an excessive financial and administrative burden.]
  - b. Operate housing in such a way that tenants are segregated based on their disabilities. [This answer is incorrect. Project owners must operate housing so as to prevent segregation based on disability, unless authorized by federal statutes or orders and to promote integration.]
  - c. Contract with an outside source to perform an independent evaluation to determine that disability discrimination exists. [This answer is incorrect. Project owners must perform a self-evaluation to confirm that disability discrimination does not exist.]



- d. **Allow the use of “service animals” by tenants with disabilities in cases where the animal is trained to perform needed assistance. [This answer is correct. Project owners must permit tenants with disabilities to use “service animals” such as guide dogs in cases where tenants are vision impaired.]**
28. A project owner is responsible for establishing a reserve fund for the purpose of making repairs and replacements of project property that are necessary. HUD Handbook 4350.1, Paragraph 4-22, states that deposits for such purpose can exceed federal insurance limits so long as the entity monitors and keeps records indicating that the financial institution has a rating in keeping with minimally acceptable ratings established by GNMA and maintains documentation of the ratings for a: **(Page 56)**
- a. Minimum of two years. [This answer is incorrect. HUD Handbook 4350.1, Paragraph 4-22, requires the entity to maintain documentation of the ratings for a minimum period of time that is longer than two years.]
  - b. **Minimum of three years. [This answer is correct. So long as the entity monitors and documents whether the financial institution has a rating consistent with minimally acceptable ratings established by GNMA and maintain documentation of the ratings for a minimum of three years, deposits can exceed the federal insurance limits.]**
  - c. Minimum of four years. [This answer is incorrect. The entity is required by HUD Handbook 4350.1 to maintain documentation of the ratings for a minimum period of time that is shorter than four years.]
29. When the difference between the total tenant payment for all units covered by the assistance payment contract and the monthly operating rent potential is a negative amount, the nonprofit owner must: **(Page 56)**
- a. Deposit that amount into the property’s residual receipts account on a bi-weekly basis. [This answer is incorrect. Deposit does not need to be made as often as bi-weekly.]
  - b. **Deposit that amount into the property’s residual receipts account on a monthly basis. [This answer is correct. Deposit should be made into the property’s residual receipts account on a monthly basis.]**
  - c. Deposit that amount into the property’s residual receipts account on a quarterly basis. [This answer is incorrect. Deposit should be made more often than quarterly.]
  - d. Deposit that amount into a separate account from the property’s residual receipts account. [This answer is incorrect. Deposit into a separate account from the property’s residual receipts account is not appropriate.]
30. One instance of noncompliance that auditors frequently encounter when performing tests of the residual receipts compliance requirement is that of entities that fail to fund the residual receipts account within how many days following a Section 202 entity’s fiscal year end? **(Page 57)**
- a. 30 days. [This answer is incorrect. Entities have longer than 30 days to fund the residual receipts account after a Section 202 entity’s fiscal year end and still remain compliant.]
  - b. **60 days. [This answer is correct. Entities that fund the residual receipts account within 60 days following a Section 202 entity’s fiscal year end are compliant with the residual receipts compliance requirement.]**
  - c. 90 days. [This answer is incorrect. Entities do not have as long as 90 days to fund the residual receipts account after a Section 202 entity’s fiscal year end in order to remain compliant.]
31. Which of the following statements concerning distributions to owners of HUD projects is accurate? **(Page 57)**
- a. Owners may receive distribution of some assets and surplus cash. [This answer is incorrect. Owners may not receive, make, and/or retain any distribution of assets or any income of any kind of the project with the exception of surplus cash, but only then under certain circumstances.]

- b. Surplus cash distributions can sometimes be made when the owner is in default under the note. [This answer is incorrect. Surplus cash distributions can never be made when the owner is in default under the note, the mortgage, or under any of the terms of the regulatory agreement.]
  - c. **Surplus cash distributions can never be made out of borrowed funds. [This answer is correct. Surplus cash distributions cannot be made out of borrowed funds or in cases where the owner has not complied with all outstanding notices, from either HUD or from the mortgagee, for proper maintenance of the project.]**
32. If a project's owner wishes to make deposits of cash receipts at an institution where deposits are federally insured in an amount that exceeds the federal insurance limits, the owner and management agent must monitor and document that the financial institution holds acceptable ratings as determined by GNMA and maintain documentation of the ratings for what period of time? **(Page 59)**
- a. A minimum of two years. [This answer is incorrect. Owners and management agents must maintain documentation of a financial institution's GNMA ratings for a minimum period of time that is greater than two years.]
  - b. **A minimum of three years. [This answer is correct. The correct minimum period of time that the owner and management agent must maintain documentation of a financial institution's GNMA rating is a period of at least three years.]**
  - c. A minimum of four years. [This answer is incorrect. Documentation of a financial institution's GNMA ratings must be maintained by the owner and management agent for a minimum period of time that is shorter than four years.]
33. Which instance of noncompliance with requirements regarding cash disbursements can subject the project owner to civil and criminal penalties? **(Page 60)**
- a. Paying unreasonable amounts to related party management agents for services provided to the project for things such as building maintenance. [This answer is incorrect. Payment of unreasonable amounts to related party management agents for services provided to the project for things such as building maintenance are considered "unallowable distributions" that should be reported in the "Schedule of Findings and Questioned Costs" regardless of materiality. Such "unallowable distributions" cannot, however, cause the project owner to be subject to civil or criminal penalties.]
  - b. **Repayment of owner advances in situations where the project is in a nonsurplus cash position prior to receiving HUD's approval. [This answer is correct. Repayment of owner advances in circumstances where the project is in a nonsurplus cash position prior to obtaining HUD's approval should be reported in the "Schedule of Findings and Questioned Costs" regardless of materiality. In addition, repaying owner advances without obtaining HUD's approval can result in the project owner being subjected to civil and criminal penalties.]**
34. According to the text, there are three primary sources of information on HUD's requirements regarding application, eligibility, and recertification. Which of the following is absent from the list of primary sources of information on HUD's requirements in those three areas? **(Page 60 and Page 61)**
- a. The Housing Assistance Payments (HAP) Contract. [This answer is incorrect. The HAP Contract is one of three primary sources of information on HUD's requirements regarding application, eligibility, and recertification of tenants in HUD-assisted projects.]
  - b. **The HUD audit guide, at Paragraph 3-5.J.1. [This answer is correct. The HUD audit guide, at Paragraph 3-5.J.1 states the compliance requirement for tenant application, eligibility, and recertification but is not identified in the text as being one of the three primary sources of information on HUD's requirements in those areas.]**
  - c. HUD HB 4350.3 REV-1 CHG-2. [This answer is incorrect. HUD HB 4350.3 REV-1 CHG-2, "Occupancy Requirements of Subsidized Multifamily Housing Programs," is another of the three primary sources of

- information covering HUD's requirements addressing application, eligibility, and recertification of tenants in HUD-assisted projects.]
- d. 24 CFR 813. [This answer is incorrect. 24 CFR 813, "Definition of Income, Rent, and Reexamination of Family Income for Section 8 and Related Programs," is identified in the text as a primary source of information on HUD's requirements in the areas of application, eligibility, and recertification of tenants in HUD-assisted projects.]
35. The compliance requirements cited in the July 2008 release of the revision to Chapter 3 of the HUD audit guide regarding tenant security deposits are accurately reflected in which of the following statements? **(Page 61)**
- a. Funds collected as a security deposit must be kept in the name of the project and may be combined with other funds of the project. [This answer is incorrect. Funds collected as a security deposit must be kept in the name of the project and must be kept separate and apart from all other funds of the project in a trust account.]
- b. Disbursements from the security deposit account should only be for refunds to tenants. [This answer is incorrect. All disbursements from the security deposit funds account must be only for refunds to tenants and for payment of expenses incurred by or on behalf of the tenant, not to exceed the amount to which the tenant is entitled.]
- c. **In addition to HUD's regulations, state and local governments may have specific regulations regarding the handling of tenant security deposits. [This answer is correct. HUD's regulations regarding the handling of tenant security deposits may not be the only regulations that must be followed. State and local governments may also have specific regulations concerning this subject.]**
36. Brad is the management agent for a HUD project and is reimbursed by the project for visiting the project. Which of the following statements accurately describes the auditor's determination as a result of the management agent being reimbursed for visiting the project? **(Page 62)**
- a. Such reimbursement of the management agent for visiting the project is normal and customary and, therefore, is separately chargeable to the project. [This answer is incorrect. HUD laws and regulations do not provide for separate charges to the project for visits by the management agent.]
- b. **Such reimbursement of the management agent for visiting the project is considered by HUD to already be included in the management fee. [This answer is correct. Separate reimbursement to the management agent for visiting the project is not in compliance with HUD laws and regulations since HUD considers such expenses to already be included in the management fee.]**
37. The operator of a leased nursing home is required to provide HUD with a financial report acceptable to that agency covering the operations of the mortgaged property and of the project within how many days of the request? **(Page 64)**
- a. 15 days. [This answer is incorrect. The operator of a leased nursing home has a period of time that is longer than 15 within which to provide HUD with a financial report.]
- b. **30 days. [This answer is correct. The correct number of days within which the operator must provide HUD with a financial report after requested to do so by HUD is 30 days.]**
- c. 45 days. [This answer is incorrect. The period of time that the operator of a leased nursing home has within which to provide HUD with an acceptable financial report subsequent to HUD request is not within 45 days.]
- d. 60 days. [This answer is incorrect. The operator of a leased nursing home must provide HUD with a financial report covering operations of the mortgaged property and of the project within a number of days fewer than 60.]

## PERFORMING AUDIT SAMPLING IN TESTS OF CONTROLS OVER COMPLIANCE

There are basically two purposes of tests of controls in a HUD audit:

- To obtain appropriate audit evidence and report separately on whether the entity has controls to provide reasonable assurance that it is managing HUD programs in compliance with applicable laws and regulations.
- To obtain a reduced control risk assessment in order to reduce the extent of substantive tests of compliance.

### Exhibit 2-2

#### Criminal and Civil Penalties

##### CRIMINAL PENALTIES

###### *Section 1715z-19, Title 12, U.S.C., "Equity Skimming Penalty"*

Provides, among other things, that whoever willfully uses or authorizes the use of any part of the rents, assets, proceeds, income, or other funds derived from the property during a period when the mortgage note is in default or the project is in a nonsurplus cash position, for any purpose other than to meet actual or necessary expenses, shall be fined not more than \$500,000 or imprisoned not more than five years, or both.

###### *Section 1001, Title 18, U.S.C., "Fraud and False Statements"*

Provides that whoever knowingly and willingly makes or uses a document or writing containing any false, fictitious, or fraudulent statement about any matter within the jurisdiction of any department or agency of the United States, shall be fined not more than \$10,000 or imprisoned for not more than five years, or both.

###### *Section 1010, Title 18, U.S.C., "H.U.D. Transactions"*

Makes it a criminal offense to make a willful false statement or misrepresentation to any federal Department or Agency about any matter within its jurisdiction. Violators shall be fined not more than \$5,000 or imprisoned not more than two years, or both.

###### *Section 1012, Title 18, U.S.C., "Department of Housing and Urban Development Transactions"*

Provides that whoever, with intent to defraud, makes false entry in any book of the Department of Housing and Urban Development, makes any false report or statement to or for HUD, or receives compensation . . . with intent to defraud HUD or with intent to unlawfully defeat its purposes shall be fined not more than \$1,000 or imprisoned not more than one year, or both.

##### CIVIL PENALTIES

###### *Sections 1715z-4a, Title 12, U.S.C., "Double Damages Remedy for Unauthorized Use of Multifamily Housing Projects Assets and Income"*

Provides for a double damages civil remedy for the use of assets or income in violation of a regulatory agreement and applicable HUD regulations.

###### *Section 1735f-15, Title 12, U.S.C., "Civil Money Penalties Against Multifamily Mortgagors"*

Provides civil money penalties and criminal penalties for project owners who have not honored their commitment with HUD to contribute nonproject (i.e., personal) funds to the project. (Such contributions may

be required as a condition to receiving flexible subsidy loans, modifications of mortgage terms, or workout agreements.)

SOURCE: *Financial Operations and Accounting Procedures for Insured Multifamily Projects* (HUD Handbook 4370.2, Appendix 1) and OIG Program Fraud Alert: *Fraud and Abuse in Multifamily Mortgage Insurance Programs*.

\* \* \*

## Objective of the Tests

The primary objective of tests of controls in a HUD audit is to determine whether the entity has controls in place to provide reasonable assurance that it is managing HUD programs in compliance with applicable laws and regulations. The HUD audit guide, Paragraph 1-6, indicates that it is the auditor's responsibility to perform tests of those controls. To accomplish that, the auditor must test the effectiveness of the design and operation of the controls in preventing or detecting material noncompliance. The process of testing controls and assessing control risk also provides audit evidence about the risk that material noncompliance exists in a major program and may permit the auditor to reduce substantive tests of compliance.

## Purpose of the Tests

The purpose of tests of controls is to evaluate the effectiveness of the design and operation of controls applicable to each HUD program that the auditor considers relevant to preventing or detecting material noncompliance with the specific requirements. Auditors should perform such tests regardless of whether they would otherwise choose to obtain evidence to support an assessment of control risk below high. However, the HUD audit guide, paragraph 1-6, makes it clear that tests of controls are not required for those areas for which controls are likely to be ineffective. In such a case, however, the internal control report should include the required communications for the internal control deficiency related to any controls not tested.

## Multi-purpose Tests

The auditor may use tests of transactions to combine substantive compliance tests of laws and regulations over major programs that involve the inspection of supporting documentation with tests of controls used in administering HUD programs. In other words, a multi-purpose (dual-purpose or triple-purpose) test of transactions is possible. The auditor selects a sample of transactions and inspects supporting documentation to determine the following:

- a. Indications of compliance with relevant laws' regulations and compliance requirements.
- b. Indications of performance of controls.
- c. Recorded in correct amount, account and period. (For a triple-purpose test.)

The guidance about sample sizes for dual purpose tests provided in SAS No. 39, as amended (AU 350.44) generally applies when a sample is used for multi-purpose testing. Accordingly, when this approach is taken, the sample size should be the largest sample size necessary to satisfy either of the separate purposes of the test. The auditor should also consider the HUD audit guide's requirements for sample sizes and sample selection for compliance tests. Separate evaluations should be made of any control deviations, noncompliance identified from the tests, or financial statement misstatements.

## Identifying Controls

The identification of controls is not changed by use of audit sampling. However, only certain types of controls are generally susceptible to testing using sampling.

Audit sampling can be used in selecting items to test when performing tests of controls over compliance with laws and regulations similar to the way that audit sampling is used in selecting items to test when performing tests of other types of controls. In practice, the most common test of controls that uses audit sampling is a test of transactions. However, not all tests of controls involve the use of audit sampling. Generally, audit sampling is only used for tests of controls for which there is documentation of the operation of the controls. Normally, those tests of controls involve inspection of documents and reports indicating performance of the policy and procedure and, in many cases, reperformance of the application of the control. For example, the most common type of control tested is a checking routine or approval evidenced by initials, signatures, or stamps on documents. The approach is usually to sample the documents, inspect items selected for evidence of performance of the control, and reperform the control to test its effectiveness.

## Defining the Population

For a test of controls using audit sampling, the auditor may define the population in one of two ways. Since a particular control often applies to the items of more than one program, the auditor may (a) define the items from each program as a separate population or (b) define all items to which the control applies as a single population. The size of the population has little or no effect on sample size; therefore, it usually will be more efficient to select one sample from all the items to which the control applies.

The sample units in those circumstances are individual transactions of a particular type, and the auditor needs to specify the physical sample unit that will be selected, for example, canceled checks when the population is cash disbursements. Also, the auditor needs to specify the conditions that will be regarded as deviations from prescribed controls.

In audits where project owners and management agents manage more than one project, the auditor should be aware that the HUD audit guide is generally intended to cover the activities of a single project/entity and not the activities of the project owner or the management agent. It is important that the auditor considers project level controls, not just entity level controls when defining the population. In such cases, samples should include items from all relevant activities at each project.

## Determining the Sample Size

The extent of tests of controls is a matter of professional judgment, but, generally, large sample sizes are not necessary. Under normal circumstances, a test of controls and the underlying transactions of a sample of 25 items from each *system* or *subsystem* is sufficient for the audit of a for-profit project owner. That sample size also corresponds to the minimum sample size for compliance sampling with a 90% confidence level and 10% tolerable rate previously discussed.

Use of professional judgment is required when combining the evidence obtained from tests of controls using audit sampling with evidence from other tests of controls that do not involve audit sampling (for example, inquiry and observation). In the auditor's judgment, the combined evidence must be sufficient to determine whether the entity has controls in place to provide reasonable assurance that it is managing its HUD programs in compliance with applicable laws and regulations. In making that judgment, the auditor should consider the following:

- The nature of the control.
- The importance of the control in ensuring compliance with laws and regulations.
- The type and extent of any tests of the effectiveness of the control performed by the entity.

## Practical Guidance on Sample Size

The auditor of a for-profit project owner usually will only need to select a sample of 25 items from each internal control system or subsystem. The auditor must be sure that all of the significant controls, as determined by the auditor, relating to major and nonmajor programs are tested. The tests of the sample of 25 items will be in addition to the tests of controls performed through inquiry and observation for those controls that do not provide documentary evidence of their performance. The selection of only 25 items is based on the auditor's planned assessed level



of control risk as moderate and no expected deviations. The auditor should note that if this test is designed as a dual-purpose test, the compliance aspect of the test would only relate to those programs from which items were selected for dual-purpose testing; whereas, if the entity has only one internal control system, the control part of the test would apply to all programs.

For a population greater than 200, the auditor's sampling approach generally involves a choice between sample sizes of 25, 40, or 60 items, depending upon the auditor's judgment about risk. The auditor should make an overall judgment based on the expected number of deviations and the planned assessed level of control risk before deciding whether to select a sample of 25, 40, or 60 items. When using a planned assessed level of control risk of moderate, there can be no deviations or errors if a sample of 25 is used; no more than one deviation for a sample size of 40; and no more than three deviations for a sample of 60.

### Selecting the Sample

The sample selection method may be random, systematic, or haphazard. Each method is appropriate for tests of controls using audit sampling. It should be emphasized, however, that block sampling (that is, selecting all the transactions of a particular type for a day, week, or month) is not acceptable. A distinctive aspect of selecting a sample for a test of controls is that if any documents necessary to perform the test are missing, the item normally has to be counted as a deviation. According to SAS No. 39, as amended (AU 350.40):

If the auditor is not able to apply the planned audit procedures or appropriate alternative procedures to selected items, he should consider the reasons for this limitation, and he should ordinarily consider those selected items to be deviations from the prescribed policy or procedure for the purpose of evaluating the sample.

However, unused and legitimately voided documents do not have to be considered as deviations.

### Other Considerations in Control Testing

It is common in practice to perform control testing on selected tenant files in a given project. Practice varies for determining the extent of this type of testing. Some auditors have chosen alternative approaches, such as using a range of 25%-50% of the tenant files, based upon the auditor's judgment and circumstances. If the auditor decides to use an alternative approach, the basis for determining the extent of control testing should be documented, and sampling applications should also be adequately documented.

In addition, if multi-purpose testing is used, the auditor should also consider the HUD audit guide's requirements for sample sizes and sample selection in compliance testing.

### Evaluating Sample Results of Tests of Controls

SAS No. 39, as amended, (AU 350.40) requires the auditor to apply auditing procedures that are appropriate for achieving the objective of the test of controls to each item in the sample. When circumstances do not enable the auditor to apply the planned audit procedures or appropriate alternative procedures to certain items, he should consider the reasons for this limitation. The auditor would also normally consider those items to be deviations for purposes of evaluating the sample.

The deviation rate in the sample is the auditor's estimate of the deviation rate in the population. If the estimated deviation rate is less than the tolerable rate, the auditor should still consider the risk that might result if the actual deviation rate in the population exceeds the tolerable rate. For example, if the tolerable rate for a population is 5% and two or more deviations are found in a sample of 60 for a large population, the auditor might conclude that there is an unacceptably high sampling risk that the actual rate of deviations in the population exceeds the tolerable rate.

In addition to evaluating the frequency of deviations, the auditor should also consider the qualitative aspects of the deviations. These include (a) the nature and cause of the deviations, such as whether they are due to noncompliance with relevant laws, regulations, or compliance requirements or due to error or fraud, and (b) the possible relationship of the deviations to other aspects of the audit.



If the sample results do not support the planned assessed level of control risk for an assertion, the auditor should reconsider the assessed level of control risk for the relevant assertion and re-evaluate the nature, timing, and extent of substantive procedures.

### **Documenting Samples for Tests of Controls**

When using audit sampling for tests of controls, the auditor should consider the professional requirements for audit documentation. SAS No. 103 (AU 339), *Audit Documentation*, indicates that auditors performing tests of operating effectiveness of controls involving inspection of documents should include in the workpapers identifying characteristics of the items tested. SAS No. 39 does not impose specific documentation requirements for audit sampling, however, the AICPA Sampling Guide at Paragraph 3.93 suggests that the auditor document the following matters:

- A description of the control being tested.
- The control objectives related to the sampling application, including the relevant assertions.
- The definitions of the population and sampling unit, including how the auditor considered the completeness of the population.
- The definition of the deviation condition.
- The acceptable risk of overreliance on controls (or desired confidence or assurance level), the tolerable deviation rate, and the expected population deviation in rate used in the application.
- The method of sample size determination.
- The method of sample selection.
- The selected sample items.
- A description of how the sampling procedure was performed.
- The evaluation of the sample and the overall conclusion.

The lack of documentation of sampling is one of the most common topics in letters of comments for peer reviews. Both AICPA standards and the Yellow Book state that the audit documentation should be sufficient to enable an experienced auditor with no connection with the audit to understand the nature, timing, extent, and results of the audit procedures performed. In addition, SAS No. 103, *Audit Documentation*, states that documentation of audit procedures, including those involving sampling, should include identifying characteristics of the specific items that were tested. This requirement specifically includes tests of the operating effectiveness of controls and substantive tests of details involving inspection of documents. Thus, the audit documentation should document all important aspects of the engagement, including the sampling and other selection criteria used, and should be sufficiently detailed to permit reasonable identification of the work done and conclusions reached.

## **AUDIT SAMPLING IN SUBSTANTIVE TESTS OF COMPLIANCE WITH LAWS AND REGULATIONS IN MAJOR HUD PROGRAMS**

As previously noted, the auditor is required to perform audit procedures to test the project owner's compliance with the specific requirements applicable to major HUD programs (except that the "Fair Housing and Non-Discrimination" specific requirement is tested for both major and nonmajor programs).

The nature of some specific compliance requirements lends themselves to sampling, and the HUD audit guide's suggested audit procedures incorporate the use of sampling for several compliance areas. Those compliance areas, such as Cash Disbursements, usually possess documentary evidence of compliance and involve large populations. Other compliance areas, because of the small population involved or the type of evidence of compliance available, do not lend themselves to sampling. Exhibit 1-2 is a list of compliance requirements that typically

are not tested using audit sampling (that is, nonsampling requirements) and compliance requirements that typically are tested using audit sampling.

### **Determining the Test Objective and Defining the Population**

The population for a test of compliance usually consists of a class of transactions that are subject to the requirements of a particular law or regulation or expenditures for a specific major HUD program. The dollar amounts of the transactions may vary significantly; therefore, the auditor should consider such variation when determining an appropriate sample size for the test. Other populations may consist of tenant lease files, HUD-required reporting packages, or applicants from the project's waiting list. When audit sampling is involved, the auditor should use judgment in defining the audit population.

The HUD audit guide emphasizes the importance of properly defining the objective of the compliance test and defining the population in the sample by pointing out that the auditor should understand and document what attribute(s) and/or assertion(s) are being tested. The HUD audit guide's suggested audit procedures are designed to test the assertion that the entity has complied with the applicable compliance requirement. For example, the audit procedures in the HUD audit guide's Tenant Application, Eligibility and Recertification audit area are designed to test whether the auditee meets the following specific requirement:

Owners who participate in HUD's rent subsidy programs are responsible for accepting applications, maintaining a waiting list, determining eligibility, calculating the tenant's contribution toward rent and utilities, calculating subsidy, and recertifying the tenant annually in accordance with HUD requirements.

The HUD audit guide's suggested audit procedures for compliance with this requirement include inspecting a sample of tenant files for evidence of compliance with specific HUD requirements. When applying sampling methods, it is important to document the sampling unit; the individual item such as a lease file, subject to sampling. Evidence of the tenant's annual recertification is an attribute of the lease file that is tested as part of the compliance test.

The HUD audit guide states that the samples selected for testing each of the applicable compliance requirement areas should be considered a separate population and samples should be selected accordingly. However, in some cases the sample selected may be used to test multiple attributes within each compliance requirement. Additionally, auditors must assess the control environment at entities with multiple locations. If controls at the different locations are significantly different, each location must be considered a separate population.

### **Determining Sample Size**

Sample size should be determined by the auditor using professional judgment and taking into consideration the assessment of inherent risk and control risk. The objectives of compliance auditing procedures are to provide sufficient, appropriate audit evidence to reasonably assure the detection of material noncompliance with specific requirements applicable to major HUD programs. Therefore, the auditor should select sample sizes that will provide appropriate evidence for that purpose. Auditors should ensure that such sample sizes meet the minimum requirements set forth in the HUD audit guide.

### **Compliance Testing of For-profit HUD Entities**

**Required Use of Attribute Sampling.** Paragraph 3-4 of the HUD audit guide specifies the attribute sampling method as the appropriate sampling method when testing compliance in accordance with the guide. In the event the auditor chooses to use a different sampling method, such as variable sampling methodology, the auditor must document the justification for the method selected in the audit workpapers. Regardless of the sampling methodology used, Appendix A to Chapter 3 of the HUD audit guide establishes minimum sample sizes that must be used when performing compliance testing in accordance with the guide. Since audits of nonprofit HUD entities are performed in accordance with OMB Circular A-133 rather than the HUD audit guide, these provisions do not have to be followed on nonprofit HUD audits. However, it is acceptable to follow these provisions since they do not conflict with the sampling guidance in OMB Circular A-133.

Appendix A to Chapter 3 of the HUD audit guides provides an overview of attribute sampling. It specifies minimum sample sizes, details the items that should be documented in the audit workpapers when performing a sample, and provides guidance on how to evaluate and report the results.

**Minimum Sample Sizes.** When performing attribute sampling, monetary materiality, such as planning materiality, and tolerable misstatement amounts are not considered. Instead, the desired confidence level, tolerable exception rate, expected exception rate (deviation), and size of the population are used. Appendix A to Chapter 3 of the HUD audit guide states that the auditor should obtain a high degree of assurance from the attribute sample by using a confidence level of 90, 95, or 99 percent. It also states that a tolerable exception rate of 5 to 10 percent is acceptable. The minimum sample sizes in the HUD audit guide reflect no deviations are expected to be found in the sample.

A minimum sample size table for populations over 200 is included that equates a 90 percent confidence level with a low importance or significance of the attribute being tested and a 95 percent confidence level with a high importance or significance as determined by auditor judgment based on knowledge of the population. Those values combined with tolerable rates of 5 and 10 percent yield minimum sample sizes of 25 to 65. However, certain qualitative factors may cause the auditor to increase the sample size based on professional judgment. These qualitative factors might include, among other things:

- First year audit for the auditor.
- Large decentralized entities.
- High number of past findings, including significant deficiencies and material weaknesses.
- Poor internal controls.
- High activity volume.
- High employee turnover.

Minimum sample sizes are also provided for small populations of less than 200. Sample sizes of five to 20 items are presented for populations of 20 to 200 items. However, none of the illustrations address sample sizes with expected deviations. Appendix A to Chapter 3 of the HUD audit guide indicates that if exceptions are observed, the auditor should investigate the nature and cause of the exception, including performing additional procedures if necessary, to determine the materiality of the compliance findings, significant deficiencies, or material weaknesses in internal control. Though the exceptions must be reported, HUD does not require that the testing be expanded. The AICPA Guide, *Audit Sampling* suggests that the auditor double the sample size. If a greater number of exceptions are noted than were planned for, doing so might allow the auditor to continue to use the sample as a basis for opining on the applicable compliance requirement.

**Workpaper Documentation.** When performing attribute sampling, the HUD audit guide requires that the following items be documented in the workpapers:

- Objective of the test.
- Description of the population.
- Definition of an exception.
- Sampling unit.
- Confidence level.
- Significance of the attribute.
- Sample size.

- Results of testing.

### Evaluating the Sample Results of Substantive Tests of Compliance

SAS No. 39, (AU 350.26) states, "The auditor should project the misstatement results of the sample to the items from which the sample was selected. ..." That requirement is met by projecting the amount of questioned costs found in the sample when performing sampling for tests of compliance. In evaluating the sampling results in a HUD audit, the auditor should compare total projected questioned costs for each major HUD program to the amount of questioned costs considered material for that program and consider the risk that such result might be obtained even though the amount of questioned costs exceeds the amount considered material (that is, sampling risk).

**Projecting the Noncompliance.** The auditor may use one of several methods to satisfy the requirement of SAS No. 39 (AU 350), to project the sample questioned costs to the population. The following is one such method presented in the AICPA Guide, *Audit Sampling*.

**Ratio Method.** The ratio of sample dollars (the total of all items selected) to population dollars (the total of the population from which the sample was selected) is used to project the sample questioned costs as follows:

$$\frac{\text{Sample questioned costs}}{\text{Sample dollars}} \times \text{Population dollars} = \text{Projected population questioned costs}$$

Thus, if an auditor has identified \$500 of sample questioned costs, sample dollars are \$60,000, and the population dollars are \$600,000, the projected questioned costs would be calculated as:

$$\frac{\$500}{\$60,000} \times \$600,000 = \$5,000 \text{ (projected population questioned costs)}$$

If the auditor determines that the projected amount of questioned costs are material to the individual program or that sampling risk is unacceptable, the auditor's report should be modified. Even though the auditor is required to project the questioned costs identified from the items sampled to the population as a whole, only the actual questioned costs resulting from the items tested need to be reported in the Schedule of Findings and Questioned Costs. Also, the scope of the audit is not required to be expanded nor is the auditor required to include a projection of questioned costs. However, the auditor must consider the potential effect of the questioned costs in reporting on the entity's financial statements and on compliance of the individual HUD programs.

### Considering Sampling Risk

In a statistical sample, sampling risk can be measured based on sample results. In a nonstatistical sample, precise measurement is not possible. However, using the sampling model discussed in this lesson, the auditor may consider sampling through answering the following questions:

- Does projected noncompliance exceed expected noncompliance? If yes,
- Does projected noncompliance exceed one-third of tolerable non-compliance?

The results of those answers can be used to assess sampling risk as follows:

- If the answer to the preceding questions is "no," the auditor usually need not be concerned about unacceptable sampling risk under this sampling model.
- If the answer to both questions is "yes," the auditor would normally assume there is an unacceptable risk that the true noncompliance exceeds tolerable noncompliance. The auditor is not required to expand the scope of his or her audit or to include a projection of questioned costs in the Schedule of Findings and Questioned Costs; however, the potential effect of the questioned costs must be considered not only on the entity's financial statements but also on compliance of the individual HUD programs. Also, a qualitative

analysis of detected noncompliance should always be made to assess the nature and cause of the noncompliance.

**Unacceptable Sampling Risk.** The auditor should take appropriate actions if the sample results indicate that planning assumptions were incorrect. For example, if the auditor discovers noncompliance in amounts or frequency that exceed those considered in the assessed levels of inherent and control risk, the auditor's risk assessments should be altered. The auditor should also consider whether to modify other audit tests that were based on the inherent and control risk assessments.

The general approach to dealing with unacceptable sampling risk is to isolate the nature and cause of the noncompliance found in the sample. The auditor should then look for additional noncompliance in the population that may have arisen from that same cause. Once those instances of noncompliance are identified, the auditor can determine the projected questioned costs. However, if the nature and cause of the instances of noncompliance in the sample cannot be isolated (if there is no detectable pattern to them), the auditor should consider performing additional substantive procedures or expanding the sample.

### Considering Qualitative Characteristics

Size and frequency of noncompliance in a sampling application are not the only factors that should be considered. According to SAS No. 39 (AU 350.27) as amended by SAS No. 111, an auditor should consider the following qualitative aspects of the noncompliance (questioned costs):

- a. The nature and cause of any questioned costs.
  - (1) Do the questioned costs result from an error (unintentional) or possible fraud (intentional)?
  - (2) If the noncompliance is the result of an error, is it due to misunderstanding of instructions or carelessness?
- b. The possible relationship of questioned costs to other phases of the audit.

The auditor's evaluation of the sample should be considered along with other relevant audit evidence when forming a conclusion about the related account balance or class of transactions. SAS No. 39, as amended, (AU 350.25) requires the auditor to apply audit procedures that are appropriate to the particular audit objective to each item in a sample. When supporting documentation cannot be located for selected items, the auditor cannot apply the planned audit procedures. In this situation, the treatment of unexamined items will depend on their effect on the auditor's evaluation of the sample results.

When testing compliance in a HUD audit, the auditor is concerned not only with the dollar amount of noncompliance but also the rate of noncompliance in the population. Therefore, the auditor should consider not only the dollar amount of questioned costs but also the number of items of noncompliance identified. Even though the dollar value of questioned costs may be insignificant, if it results from numerous instances of small dollar items of noncompliance, the auditor should consider the overall effect on determining whether the program is or is not in compliance. The qualitative aspects of the instances of noncompliance should also be considered. For example, the auditor should also consider how the inability to examine items affects the assessment of the risks of material misstatement due to fraud, the assessed level of control risk that the auditor expects to be supported, or the degree of reliance on management representations.

### Documenting the Substantive Sampling Application

Although SAS No. 39, as amended, does not impose specific documentation requirements for audit sampling, SAS No. 103 (AU 339.03) requires that workpapers be sufficient to document that the applicable fieldwork standards have been observed. In other words, the workpapers should show that SAS No. 39 has been complied with. Both AICPA standards and the Yellow Book state that the audit documentation should be sufficient to enable an experienced auditor with no connection with the audit to understand the nature, timing, extent, and results of the audit procedures performed. In addition, SAS No. 103, states that documentation of audit procedures, including those involving sampling, should include identifying characteristics of the specific items that were tested. This

requirement specifically includes tests of the operating effectiveness of controls and substantive tests of details involving inspection of documents. Thus, the audit documentation should document all important aspects of the engagement, including the sampling and other selection criteria used, and should be sufficiently detailed to permit reasonable identification of the work done and conclusions reached.





**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

38. What is the maximum criminal penalty that may be imposed for knowingly and willingly making or using a document containing any false, fictitious, or fraudulent statement concerning any matter that falls within the jurisdiction of any department or agency of the United States?
- a. A fine not greater than \$500,000 or imprisonment for not more than five years, or both.
  - b. A fine not greater than \$10,000 or imprisonment for not more than five years, or both.
  - c. A fine not greater than \$5,000 or imprisonment for not more than two years, or both.
  - d. A fine not greater than \$1,000 or imprisonment for not more than one year, or both.
39. If the auditor of a for-profit project owner has a planned assessed level of control risk as moderate with no expected deviations, a minimum sample of how many items from each internal control system or subsystem will be needed?
- a. 15 items.
  - b. 25 items.
  - c. 35 items.
40. When an auditor uses a planned assessed level of control risk of moderate, how many deviations can there be for selecting a sample of 40?
- a. No deviations.
  - b. No more than one deviation.
  - c. No more than two deviations.
  - d. No more than three deviations.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

38. What is the maximum criminal penalty that may be imposed for knowingly and willingly making or using a document containing any false, fictitious, or fraudulent statement concerning any matter that falls within the jurisdiction of any department or agency of the United States? **(Page 74, Exhibit 2-2)**
- a. A fine not greater than \$500,000 or imprisonment for not more than five years, or both. [This answer is incorrect. A fine not greater than \$500,000 or imprisonment for not more than five years, or both is the criminal penalty that may be imposed for what is known as “equity skimming”, willfully using or authorizing the use of any part of the rents, assets, proceeds, income, or other funds derived from the property during a period when the mortgage not is in default or the project is in a nonsurplus cash position, for any purpose other than to meet actual or necessary expenses. (Section 1715z-19, Title 12, U.S.C., “Equity Skimming Penalty”)]
  - b. A fine not greater than \$10,000 or imprisonment for not more than five years, or both. [This answer is correct. Section 1001, Title 18, U.S.C., “Fraud and False Statements”, imposes a fine not greater than \$10,000 or imprisonment for not more than five years, or both, for whoever knowingly and willingly makes or uses a document or writing containing any false, fictitious, or fraudulent statement about any matter within the jurisdiction of any department or agency of the United States.]**
  - c. A fine not greater than \$5,000 or imprisonment for not more than two years, or both. [This answer is incorrect. A fine not greater than \$5,000 or imprisonment for not more than two years, or both is the criminal penalty that may be imposed for making a willful false statement or misrepresentation to any federal Department or Agency concerning any matter within its jurisdiction. (Section 1010, Title 18, U.S.C., “HUD Transactions”)]
  - d. A fine not greater than \$1,000 or imprisonment for not more than one year, or both. [This answer is incorrect. A fine not greater than \$1,000 or imprisonment for not more than one year, or both may be imposed for whoever, with intent to defraud, makes false entry in any book of the Department of Housing and Urban Development, makes any false report or statement to or for HUD, or receives compensation with intent to defraud HUD or with intent to unlawfully defeat its purposes. (Section 1012, Title 18, U.S.C., “Department of Housing and Urban Development Transactions”)]
39. If the auditor of a for-profit project owner has a planned assessed level of control risk as moderate with no expected deviations, a minimum sample of how many items from each internal control system or subsystem will be needed? **(Page 77)**
- a. 15 items. [This answer is incorrect. If the auditor’s planned assessed level of control risk is moderate with no deviations anticipated for a for-profit project owner, the auditor will need more than 15 items from each internal control system or subsystem.]
  - b. 25 items. [This answer is correct. The auditor will need to select a minimum of 25 items from each internal control system or subsystem for a for-profit project owner where the auditor’s planned assessed level of control risk is moderate and no deviations are expected.]**
  - c. 35 items. The answer is incorrect. The auditor will need a minimum sample of fewer than 35 items from each internal control system or subsystem for a for-profit project owner when the auditor has a planned assessed level of control risk as moderate with no deviations expected.]

40. When an auditor uses a planned assessed level of control risk of moderate, how many deviations can there be for selecting a sample of 40? **(Page 77)**
- a. No deviations. [This answer is incorrect. When an auditor uses a planned assessed level of control risk of moderate and no deviations are expected, a sample of less than 40 can be used.]
  - b. No more than one deviation. [This answer is correct. When the auditor selects a sample of 40 with a planned assessed level of control risk of moderate, there can be no more than one deviation.]**
  - c. No more than two deviations. [This answer is incorrect. There is not a sample size cited for which the number of deviations can be no more than two.]
  - d. No more than three deviations. [This answer is incorrect. There can be no more than three deviations when using a planned assessed level of control risk of moderate for a sample of 60.]



**EXAMINATION FOR CPE CREDIT****Lesson 2 (HUDTG092)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

20. How frequently are reports required by HUD in cases where on-site reviews, annual financial reviews, or other information indicates that the project is experiencing management or financial difficulties or the owner/agent is suspected of being noncompliant?
  - a. Weekly.
  - b. Bi-weekly.
  - c. Monthly.
  - d. Quarterly.
21. Of the following groups, which one *must* be given preference by owners of Section 236 properties when selecting housing applicants?
  - a. Applicants displaced by government action.
  - b. Victims of domestic violence.
  - c. Homeless or disabled individuals.
  - d. Elderly individuals.
22. Owners of some HUD-insured projects are exempt from the requirements of which of the following?
  - a. The Fair Housing Act.
  - b. HUD Handbook 4350.3 REV-1.
  - c. Applicable state and local law.
  - d. Do not select this answer choice.
23. The auditor is required by the HUD audit guide to report on the entity's compliance with "Fair Housing and Non-Discrimination" specific compliance requirements if the program the project owner receives assistance under is which of the following?
  - a. Nonmajor program.
  - b. Major program.
  - c. Nonmajor or major program.
  - d. Do not select this answer choice.
24. A residual receipts accounts must be established by owners of Section 811 projects and they must make deposits into the account pursuant to HUD requirements within how many days after the close of the fiscal year?
  - a. 60 days.
  - b. 90 days.
  - c. 120 days.
  - d. 180 days.

25. Under certain conditions, surplus cash can be deposited in the reserve fund for replacements rather than in a residual receipts account by which of the following?
- a. Nonprofit owners.
  - b. Owners of limited distribution projects.
  - c. Section 811 projects.
  - d. Section 202 projects.
26. Distributions to owners of for-profit HUD entities are classified as allowed or unallowed in accordance with the terms of its regulatory agreement with HUD. Where are unallowed distributions reported?
- a. In the management letter.
  - b. In the report on illegal acts.
  - c. In the Schedule of Findings and Questioned Costs.
  - d. In a footnote.
27. In accordance with the July 2008 release of the revision to Chapter 3 of the HUD audit guide, all cash receipts must be deposited in an account in the name of the project at a financial establishment where deposits are federally insured. The project's owner is responsible for verifying that financial institutions where its funds are maintained in excess of \_\_\_\_\_ meet certain conditions that are detailed in HUD Handbook 4370.2, Chapter 2, including whether the financial establishment has a rating that is consistent with minimally acceptable ratings established by GNMA and maintain documentation of those ratings for a specified period of time.
- a. \$50,000.
  - b. \$100,000.
  - c. \$200,000.
  - d. \$250,000.
28. Which of the following should be reported as questioned costs in the "Schedule of Findings and Questioned Costs" rather than as cash disbursements?
- a. Material expenditures outside distributions of surplus cash.
  - b. The "provisions for project expenses."
  - c. Distributions of surplus cash.
  - d. Do not select this answer choice.
29. The HUD audit guide requires owners who participate in HUD's rent subsidy programs to recertify the tenant in accordance with HUD requirements at what intervals?
- a. Every 90 days.
  - b. Every 180 days.
  - c. Annually.
  - d. Bi-annually.

30. A substantial rehabilitation project is subject to "revised Section 8 regulations" if the project owner received their notice of funds reservation on or after:
- a. November 5, 1979.
  - b. November 20, 1979.
  - c. February 5, 1980.
  - d. February 20, 1980.
31. A project owner's security deposit account should have sufficient funds to make refunds to what percent of the total number of tenants at any given point in time?
- a. 50%.
  - b. Two-thirds.
  - c. 75%.
  - d. 100%.
32. Within what timeframe from the end of the month in which it was collected, must owners of properties with mortgages insured under Section 236 of the National Housing Act submit excess income?
- a. 7 days.
  - b. 10 days.
  - c. 14 days.
  - d. 21 days.
33. Which of the following describes the penalty imposed by Sections 1715z-4a, Title 12, U.S.C., for the use of assets or income in violation of a regulatory agreement and applicable HUD regulations?
- a. Double damages civil remedy.
  - b. Monetary penalties and criminal penalties.
  - c. Do not select this answer choice.
  - d. Do not select this answer choice.
34. Normally, for the audit of a for-profit project owner, the auditor usually will only need to select a sample of how many items from each internal control system or subsystem?
- a. 15.
  - b. 20.
  - c. 25.
  - d. 30.



35. There are three sample selection methods that are considered appropriate for tests of controls using audit sampling. Which of the following is **not** one of the sample selection methods considered appropriate?
- a. Systematic.
  - b. Block.
  - c. Haphazard.
  - d. Random.
36. When the auditor is performing a HUD audit, which of the following approaches maximizes efficiency when testing transactions and/or controls?
- a. First perform an audit of the project owner's compliance with HUD requirements.
  - b. First perform an audit of the financial statements.
  - c. Perform an audit of the project owner's compliance and the financial statements simultaneously.
  - d. Do not select this answer choice.
37. Which of the following documents suggests that certain specified matters be documented by the auditor even though specific documentation requirements for audit sampling are not imposed by SAS No. 39, *Audit Sampling*?
- a. SAS No. 103, *Audit Documentation*.
  - b. SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.
  - c. SAS No. 111, *Amendment to Statement on Auditing Standards No. 39, Audit Sampling*.
  - d. The Audit Sampling Guide at Paragraph 3.93.
38. Appendix A to Chapter 3 of the HUD audit guide indicates that the auditor should obtain a high degree of assurance from the attribute sample when performing attribute sampling by using a confidence level of 90, 95, or 99 percent. It also indicates that a tolerable exception rate of what percent is acceptable?
- a. 3 to 5 percent.
  - b. 5 to 7 percent.
  - c. 5 to 10 percent.
  - d. 7 to 10 percent.
39. Bill is performing an audit and wants to project the amount of questioned costs he has found in the representative sample to the items from which the sample was selected. He has identified \$1,000 of sample questioned costs, \$120,000 of sample dollars, and population dollars of \$1,200,000. The projected population questioned costs, using rounding in the calculation, would be:
- a. \$10,000.
  - b. \$100,000.
  - c. \$1,200,000.
  - d. \$10,000,000.

40. If projected noncompliance exceeds \_\_\_\_\_ of tolerable noncompliance, the auditor generally will assume there is an unacceptable risk that the true noncompliance exceeds tolerable noncompliance.
- a. One-fourth.
  - b. One-third.
  - c. One-half.
  - d. Two-thirds.



## GLOSSARY

**Amortization:** Reduction of a debt by periodic charges to assets or liabilities, such as payments on mortgages.

**Capital advance program:** A program that provides funding in the form of a capital advance (grant) to finance the construction, rehabilitation or acquisition of housing by very low income individuals, elderly persons, or persons with disabilities, through an annual competitive application process. Repayment of the capital advance is not required provided the housing remains available for occupancy by very low-income individuals of the target population for at least 40 years.

**Cash equivalence:** The market value of an item if sold for cash. In real estate it represents the value of property sold, when can be different from the stated selling price.

**Coinsured mortgage:** A mortgage in which the insurer provides indemnity for only a certain percentage of the insured's loss, reflecting the relative division of risk between insurer and insured.

**Default:** Failure of a debtor to make timely payments of interest and principal as they come due or to meet some other provision of a bond, mortgage, lease, or other contract.

**Disbursement:** Paying out of money in the discharge of a debt or an expense.

**Equity skimming:** The misuse or diversion of project assets or income by project owners or management agents.

**Indemnify:** To insure; to secure against loss or damage that may occur in the future; to compensate for loss or damage already suffered.

**LIHTC program:** The LIHTC program is an indirect Federal subsidy used to finance the development of affordable rental housing for low-income households.

**Marketable debt securities:** Debt securities that are easily sold. On a corporation's balance sheet, they are debts that can be readily converted into cash such as government securities, bankers' acceptances, and commercial paper.

**Mark-to-Market (M2M) restructuring program:** Involves the restructuring of debt on certain multifamily properties insured by the Federal Housing Administration (FHA) that have above market rents on their Section 8 contracts.

**Mortgagee:** One who holds a lien on property or title to property as security for a debt; lender with collateral.

**Mortgagor:** One who pledges property as security for a loan.

**Mortgage insurance:** Insurance that is generally required by lenders of those who borrow 90% of a home's price. It will indemnify the lender in case of foreclosure of the loan. Indemnification is typically limited to losses suffered by the lender in the foreclosure process, up to 20% of the home's cost.

**Multifamily housing:** A residential structure with more than one dwelling unit in the same building.

**Operating expense:** The amount paid to maintain property, such as property taxes, utilities, and hazard insurance.

**Residual receipts account:** Account established by a project owner if distributions of cash to the owners are limited or not permitted.

**Rent subsidy program:** Payment of rent by the government to certain individuals or groups of economic entities, usually to encourage their continued existence, growth, development, and profitability.

**Risk-sharing program:** A mortgage insurance program that is combined with construction and permanent financing for the creation of multifamily rental housing.

**Section 8 program:** The Section 8 program is HUD's major program for assisting very low income families, the elderly, and people with disabilities in affording decent, safe, and sanitary housing in the private market.

**Surplus cash:** The remainder of a fund appropriated for a particular purpose.

**Tests of controls:** Tests of control are those activities performed by the auditor during the control testing stage that gather evidence as to the operational effectiveness of internal control procedures upon which the auditor has planned reliance.

**Title I loans:** HUD loans that are used primarily for property improvements or for purchases of manufactured homes, such as mobile homes.

**Title II loans:** HUD loans that are used to provide financing to owners of single family and multifamily housing.

**Tolerable noncompliance:** For Section 8 and other rent subsidy HUD programs, tolerable noncompliance (materiality) is generally considered to be 5% of total assistance received.

**Transaction-related requirement:** A requirement that determines whether the types of goods or services the entity purchased under HUD regulations are allowable.

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## COMPANION TO PPC'S GUIDE TO HUD AUDITS

## COURSE 2

HUD MULTIFAMILY HOUSING, COMPLIANCE AUDITS, AND LOW-INCOME HOUSING  
TAX CREDIT PROJECTS (HUDTG092)

## OVERVIEW

**COURSE DESCRIPTION:** This interactive self-study course consists of three lessons. The first lesson covers HUD-assisted programs including features such as insured loan programs, risk sharing programs and rent subsidy programs. The first lesson also discusses contracts and forms that are of interest to auditors. The second lesson discusses the compliance audit portion of the HUD audit and focuses primarily on the compliance audits of nonsupervised mortgagees, loan correspondents and lenders. Lesson three provides an overview of the low-income housing tax credit and explains the services that auditors may provide to these projects. The effect of recently enacted legislation on these projects is also discussed.

**PUBLICATION/REVISION DATE:** July 2009

**RECOMMENDED FOR:** Users of *PPC's Guide to HUD Audits*

**PREREQUISITE/ADVANCE PREPARATION:** Basic knowledge of auditing

**CPE CREDIT:** 7 QAS Hours, 7 Registry Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at [www.nasba.org](http://www.nasba.org) for a listing of states that accept QAS hours.

**Yellow Book CPE Credit:** This course is designed to assist auditors in meeting the continuing education requirements included in GAO's Government Auditing Standards.

**FIELD OF STUDY:** Auditing (Governmental)

**EXPIRATION DATE:** Postmark by **September 30, 2010**

**KNOWLEDGE LEVEL:** Basic

**Learning Objectives:****Lesson 1—HUD Multifamily Housing—Program Features, Contracts, and Forms**

Completion of this lesson will enable you to:

- Describe the basic features of HUD's insured loan and coinsured loan programs, direct loan programs, capital advance programs, flexible subsidy programs, and rent subsidy programs.
- Identify contracts and forms that pertain to all HUD projects and those forms that are unique to rent subsidy programs.

**Lesson 2—Compliance Audits of Nonsupervised Mortgagees, Loan Correspondents, and Lenders**

Completion of this lesson will enable you to:

- Define terms and compliance requirements for HUD audit programs.
- Summarize compliance requirements applicable to Title II nonsupervised mortgagees and loan correspondents and those compliance requirements that are specifically applicable to Title I nonsupervised lenders and loan correspondents.

**Lesson 3—Low-Income Housing Tax Credit Projects**

Completion of this lesson will enable you to:

- Describe project requirements and tax credit calculation and define roles for auditors in the LIHTC program.
- Summarize compliance issues related to the initial completion of the LIHTC project as well as ongoing compliance responsibilities.

**TO COMPLETE THIS LEARNING PROCESS:**

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation**, and payment to:

**Thomson Reuters  
Tax & Accounting—R&G  
HUDTG092 Self-study CPE  
36786 Treasury Center  
Chicago, IL 60694-6700**

See the test instructions included with the course materials for more information.

**ADMINISTRATIVE POLICIES:**

For information regarding refunds and complaint resolutions, dial (800) 323-8724 for Customer Service and your questions or concerns will be promptly addressed.

# Lesson 1: HUD Multifamily Housing—Program Features, Contracts, And Forms

## INTRODUCTION

This lesson describes the basic features of the following HUD-assisted programs:

- a. Multifamily mortgage insurance programs.
- b. Coinsured loan programs.
- c. The multifamily risk-sharing program.
- d. The direct loan, capital advance, flexible subsidy, and grant programs.
- e. Rent subsidy programs.

Additional program information is available on HUD's website at [www.hud.gov/offices/hsg/mfh/progdsc/progdsc.cfm](http://www.hud.gov/offices/hsg/mfh/progdsc/progdsc.cfm).

This lesson also describes HUD contracts and forms that are of significance to auditors:

- a. General contracts and forms that pertain to all HUD projects.
- b. Documents unique to HUD's rent subsidy programs.

### Considerations for the American Recovery and Reinvestment Act of 2009

The American Recovery and Reinvestment Act of 2009 (Recovery Act) enacted in February 2009, provides almost \$800 billion in stimulus funds, of which approximately \$13.6 billion is allocated for projects and programs administered by HUD. These federal funds are intended to supplement existing federal programs, create new programs, or provide more broad fiscal relief. Most of the Recovery Act funds administered by HUD will be passed through to state and local governments and public and Indian housing authorities. However, both profit-motivated and nonprofit multifamily HUD project owners are eligible for the following Recovery Act programs:

- The *Green Retrofit Program for Multifamily Housing*. This grant and loan program is available for HUD-assisted projects that have already received assistance under Section 202 of the Housing Act of 1959, Section 811 of the Cranston-Gonzalez National Affordable Housing Act, or Section 8 of the United States Housing Act of 1937.
- The *Project-Based Rental Assistance Program*. The Recovery Act appropriated approximately \$2 billion appropriation for Section 8 housing assistance programs.

The Recovery Act will also have a significant impact on the Low Income Housing Tax Credit (LIHTC) program by appropriating \$2.25 billion to fund the *Tax Credit Assistance Program* (TCAP). Many multifamily projects that benefit from HUD multifamily programs are structured to qualify for the LIHTC.

### Learning Objectives:

Completion of this lesson will enable you to:

- Describe the basic features of HUD's insured loan and coinsured loan programs, direct loan programs, capital advance programs, flexible subsidy programs, and rent subsidy programs.
- Identify contracts and forms that pertain to all HUD projects and those forms that are unique to rent subsidy programs.

## MULTIFAMILY INSURANCE PROGRAMS

### Summary of Program Provisions

HUD oversees operations of the Federal Housing Administration (FHA), which provides mortgage insurance for single family and multifamily residences under various programs. HUD multifamily insurance programs are authorized by Title II of the National Housing Act of 1934. Under the programs, FHA insured loans are made by FHA-approved, private lending institutions, such as banks, savings and loans, and insurance companies, to owners of rental housing projects; condominiums and housing cooperatives; and hospitals, nursing homes, and health care facilities. Depending on the program, proceeds from insured loans may be used to finance the (a) acquisition, refinancing, repair, or rehabilitation of existing multifamily housing or (b) construction of new housing.

Project owners apply for assistance through HUD field offices. For insured loans, project owners (that is, mortgagors) may be individuals, partnerships, trusts, or corporations. They may be either publicly held or nonpublic, either nonprofit or profit-motivated.

To be eligible for HUD insurance, a project must meet the following requirements:

- a. The project must be located on real estate held in fee simple or subject to a lease meeting HUD criteria.
- b. The property must be free and clear of all liens other than the insured mortgage.
- c. The project must be "economically feasible" (as defined by HUD).
- d. Project owners must have permanent commitment of adequate construction and mortgage financing, contingent only on approval of the project for mortgage insurance.

The amount of insurance provided by HUD is determined by statute. For projects owned by profit-motivated mortgagors, HUD essentially insures 90% of the approved mortgage amount. For nonprofit programs, however, HUD generally insures 100% of the financing. (The "maximum insurable mortgage" is calculated on FHA Form 2580.) The maximum term of the mortgage generally is the lesser of 40 years or 75% of the remaining economic life of the project. Program provisions require projects to pay a mortgage insurance premium.

In exchange for HUD insurance, mortgagors of all HUD-insured programs are subject to regulations and various controls over certain aspects of project operations (for example, limits on rates of return and rental amounts, requirements to pay a mortgage insurance premium, and eligibility of project tenants). For most programs, the restrictions are set forth in the Regulatory Agreement. Common financial restrictions call for monies to be set aside for future replacement of structural elements and equipment, limit the amount and frequency of distributions to project owners, and require HUD approval of the amount of rent charged.

HUD-insured programs do not determine tenant eligibility based on tenant income, although certain programs are designated for low and moderate income families. As indicated in the preceding paragraph, rents are regulated by HUD, however. The maximum rent that may be charged, which is tailored to the market conditions of each project, is set at an amount determined by HUD to be adequate to service the mortgage, meet all project expenses, and provide project owners with a prescribed return on their investment. Tenants whose incomes do not exceed established income ceilings also are eligible to receive rental assistance under certain HUD rent subsidy programs.

Under HUD's multifamily insurance programs, leases may not be executed for "transient or hotel purposes." Thus, they may not be for a period less than 30 days nor may the tenants be provided with customary hotel services, such as the furnishing or laundering of linens or maid services.

### Multifamily Accelerated Processing (MAP)

In an effort to streamline the application process for mortgage insurance, HUD developed Multifamily Accelerated Processing (MAP). MAP is a more efficient process for HUD-approved lenders to apply for multifamily mortgage insurance, utilizing procedures and practices used by the private lending industry for multifamily projects. See [www.hud.gov/offices/hsg/mfh/map/maphome.cfm](http://www.hud.gov/offices/hsg/mfh/map/maphome.cfm) for more information on MAP.

On July 22, 2008, HUD issued Mortgagee Letter 2008-19, *Streamlined Processing of Multifamily Mortgage Insurance Applications Involving Low Income Housing Tax Credits*. This document establishes new procedures under MAP to streamline the processing of mortgage insurance applications for certain projects involving the Low Income Housing Tax Credit (LIHTC). The LIHTC is a federal income tax credit administered by the states that was established to encourage and finance new construction and rehabilitation of existing housing for low-income households. Many multifamily projects that benefit from HUD insurance and rental subsidy programs are structured to qualify for the LIHTC.

Among other changes in Mortgage Letter 2008-19, the cash escrow requirement for LIHTC syndication proceeds was substantially changed. The prior policy required 100% of LIHTC tax credit proceeds to be deposited in cash with the mortgagee before initial endorsement of the mortgage loan. As stated in the mortgagee letter, this policy “imposed a significant substantial financial burden on the mortgagor, who must secure costly bridge financing to fund the escrow, increases transaction soft costs substantially, and is a deterrent to closing LIHTC transactions”. The Mortgagee Letter recommends a cash escrow requirement of 20% of LIHTC proceeds, but a lower amount could be permitted with special approval.

The streamlined policies established in mortgagee letter 2008-19 will affect new multifamily projects that will qualify for the LIHTC and that apply for HUD insurance under the following programs:

- Section 220 Mortgage Insurance for Urban Renewal Projects.
- Section 221 Multifamily Rental Housing for Low and Moderate Income Families.
- Section 231 Mortgage Insurance for Housing for the Elderly and Handicapped.

## **HUD Multifamily Insurance Programs**

The remainder of this section discusses the key features of the principal HUD multifamily insured loan programs.

### **Section 207 Multifamily Rental Housing**

Section 207 of the National Housing Act offers insured loans for the construction or rehabilitation of residential rental housing consisting of at least five units. The housing must be built in an area approved by HUD, and the market conditions must support the need for housing. Although tenant eligibility is not based on income, Section 207 allows amenities such as swimming pools and air conditioning and, thus, is considered to be targeted to moderate income families. HUD generally limits Section 207 projects to profit-motivated owners.

The maximum insurable mortgage under the program is limited to the lesser of (a) the total of statutory amounts prescribed per unit based on the number of bedrooms in the unit or (b) 90% of the *HUD-estimated value* of the project. (For most other HUD insurance programs, the maximum insurable mortgage is based on project cost rather than project value.) Increases above the preceding limits may be permitted in high cost areas. The maximum term of a Section 207 mortgage is 40 years.

Although the Section 207 program is authorized, it is no longer used for new construction and substantial rehabilitation. Developers and lenders prefer the more advantageous programs available under Sections 221(d)(3) and 221(d)(4). Section 207 is, however, the primary insurance vehicle for the Section 223(f) refinancing program.

### **Section 207 Manufactured Home Parks**

Section 207 of the National Housing Act also assists profit-motivated owners in financing the construction or rehabilitation of mobile home parks consisting of at least five spaces. The program is similar to the Section 207 multifamily rental housing program discussed above in many respects. For example, the park must be located in an area approved by HUD in which market conditions show a need for such housing; tenant eligibility is not based on tenant income; and, the maximum insurable mortgage is based on project value rather than project cost. However, the maximum mortgage term for manufactured home parks is generally 20 years.

The Section 207 program is authorized, but few new projects are insured under this program.

## Section 213 Cooperative Housing

Section 213 of the National Housing Act insures loans for new construction and substantial rehabilitation of cooperative housing projects. Under the program, mortgages have been primarily provided to projects owned by nonprofit housing cooperatives that provide housing for members of the cooperative. However, mortgage insurance is also available for projects that owners intend to sell to nonprofit housing cooperatives and for projects composed of individual homes to be bought by cooperative members with separately insured mortgages. For new construction, mortgage insurance is available for a maximum term of 40 years and cannot exceed 98% of replacement cost of the project as estimated by HUD. For rehabilitation projects, mortgagors may finance 98%–100% of the rehabilitation costs depending on whether the project (a) is owned by the cooperative or subject to an existing mortgage or (b) is to be purchased by a housing cooperative with a part of the insured mortgage and subsequently rehabilitated. Section 8 rental assistance generally is not coupled with Section 213 projects.

The Section 213 program is authorized, but few new projects are insured under this program. In fiscal year 2008, only 4 projects totaling 227 units with an aggregate insured loan commitment of \$17.1 million were approved in this program. Most cooperatives now receive assistance under the Section 221(d)(3) insured loan programs.

## Section 220 Mortgage Insurance for Urban Renewal Projects

Section 220 of the National Housing Act insures loans made to multifamily housing projects in designated urban renewal areas. The program was used in the 1960s primarily to develop downtown rental housing; few new projects are insured under this program.

## Section 221 Multifamily Rental Housing for Low and Moderate Income Families

Sections 221(d)(3) and 221(d)(4) of the National Housing Act assist profit-motivated, limited distribution, and nonprofit owners in the construction or substantial rehabilitation of housing for low and moderate income families. Eligible projects include multifamily rental housing, cooperatives, and Single Room Occupancy projects that consist of one-room units occupied by single persons. HUD insured mortgages for 92 projects with 14,652 units, totaling \$1 billion, in fiscal year 2008 under these programs. Both Section 221(d)(3) and Section 221(d)(4) projects are sometimes coupled with Section 8 rental assistance.

The mortgage insurance programs under Sections 221(d)(3) and 221(d)(4) are similar in many respects to those discussed in the previous paragraphs:

- a. Tenant eligibility is not restricted by income except for Section 8 units.
- b. If the project is subsidized, HUD regulates rents for both Section 221(d)(3) and 221(d)(4) projects based on project costs and distributions to owners and must approve rents.
- c. Maximum mortgage maturity is 40 years; the mortgage interest rate is negotiated by the project owner and the lender.

In addition, project owners (except owners of rehabilitation projects with mortgages under specified dollar limits) generally are required to set aside funds with the mortgagee as a “reserve fund for replacements.” (Cooperative mortgagors are generally required to maintain a “general operating reserve.”) Provisions for accumulating, using, and replenishing reserves are generally detailed in the regulatory agreement.

The principal difference between the Section 221(d)(3) and 221(d)(4) programs is the loan-to-value ratios available to project owners. HUD insures up to 100% of replacement cost under Section 221(d)(3) projects owned by nonprofit or cooperative owners. Profit-motivated owners of Section 221(d)(3) projects and all Section 221(d)(4) projects can finance only up to 90% of replacement cost.

**Below Market Interest Rate (BMIR) Financing.** Section 221(d)(3) previously provided a Below Market Interest Rate (BMIR) program that provided financing at below market rates for the construction of low income housing. It was subsequently replaced by the Section 236 Interest Rate Reduction Program.



## **Section 223(f) Insurance for the Purchase or Refinancing of Existing Projects**

Section 223(f) of the National Housing Act provides insured loans to purchase or refinance existing projects requiring less than moderate rehabilitation to make them marketable under current conditions. Under the program, mortgage insurance is available (a) for the purchase or refinancing of existing apartment projects, (b) to refinance existing cooperative housing projects, or (c) for the purchase and conversion of existing rental projects to cooperative housing. Eligible projects must contain at least five units and must be at least three years old. Since projects may not undergo substantial rehabilitation, Section 223(f) limits the amount of repairs that can be made. HUD insured mortgages for 228 projects with 21,436 units, totaling \$942 million, in fiscal year 2008 under these programs.

For projects to be acquired under Section 223(f), the maximum mortgage available is 85% of the cost of the project plus initial amounts required to be set aside as a reserve fund for replacements and the estimated cost of necessary repairs, if any (90% for a cooperative project). For projects to be refinanced, the maximum mortgage is the greater of 70% of the value of the project or the cost to refinance the existing indebtedness. The mortgage term generally cannot be less than 10 years nor greater than 35 years.

## **Section 223(a)(7) Insurance for the Refinancing of Existing Projects**

Section 223(a)(7) of the National Housing Act provides insured mortgages for refinancing of any HUD-insured multifamily project, including nursing homes. The loan amount is the lesser of (a) the original mortgage amount, (b) the unpaid balance of the original mortgage amount plus cost of improvement, additional debt used for betterments, and loan closing charges, or (c) the amount that can be amortized as the same percentage of net operating income as allowed under the original insuring program. The loan term may not exceed the remaining term of the existing mortgage plus twelve years if required for project feasibility. HUD insured mortgages for 84 loans with 9,417 units totaling \$283 million in fiscal year 2008 under these programs.

## **Section 231 Mortgage Insurance for Housing for the Elderly and Handicapped**

Section 231 of the National Housing Act insures loans to finance the construction or rehabilitation of rental housing, at least half of which are occupied by persons age 62 or older and handicapped persons. Since eligible projects under the program are specifically designed for the elderly and the handicapped, they typically include special facilities such as congregate dining rooms, lounges, and recreational and library areas. Project owners must ensure that the elderly and handicapped are given priority in renting. Like other HUD-insured programs, income limitations apply to tenants receiving Section 8 or other rental assistance.

Numerous projects have been financed under Section 231 since the program was established in 1959. The Section 231 program is still authorized, but few new projects are insured under this program. Multifamily housing for the elderly is now generally financed under Sections 221(d)(3) and 221(d)(4). In 2008, HUD insured mortgages for four projects with 480 units totaling \$12 million.

## **Section 232 Mortgage Insurance for Nursing Homes**

Section 232 of the National Housing Act insures loans for financing the construction or renovation of nursing homes, intermediate care facilities, and board and care homes. Nursing homes, intermediate care facilities, and board and care facilities are specifically defined in the enabling legislation for the program. Eligible projects, however, generally accommodate 20 or more patients requiring skilled nursing care and related medical services or minimum but continuous care provided by licensed or trained personnel. Nursing home, intermediate care, and board and care services may be combined in the same facility covered by an insured mortgage, or they may be in separate facilities.

Section 232 provides a maximum mortgage of 90% of the estimated value of the project if the project owner is profit-motivated, increasing to 95% for nonprofit owners. Major equipment needed to operate the facility plus installation costs may also be included in the mortgage. HUD insured mortgages for 183 projects with 20,284 beds/units, totaling \$1.2 billion, in fiscal year 2008 under this program.



## Section 234(d) Mortgage Insurance for Condominiums

Section 234(d) of the National Housing Act provides insured loans to finance the construction or substantial rehabilitation of housing projects that owners intend to sell as condominiums. Mortgage limits for new construction under Section 234(d) cannot exceed 90% of the replacement cost of the project. Mortgages for rehabilitation projects can finance 100% of repair or rehabilitation costs if the project is not subject to an existing mortgage, but a lesser amount if the rehabilitation project includes either a refinancing or is to be acquired and rehabilitated. No loans have been insured under this program for several years.

## Section 236 Interest Reduction Program

Section 236 of the National Housing Act insures loans for new construction and substantial rehabilitation. In addition, the Section 236 program offers an interest rate subsidy that effectively can lower the project owner's interest rate to 1%. In turn, lower and moderate income tenants benefit from the interest subsidy payments through reduced rents. Under the Section 236 program, the owner calculates two rent payments for each tenant—one based on a mortgage that carries a market interest rate (referred to as the *market* rent) and another based on a 1% mortgage (referred to as the *basic* rent). Each tenant is required to pay the higher of the basic rent or 30% of the tenant's adjusted income. The amount paid by the tenant, however, cannot exceed the market rent. Both the basic rents and market rents for each type of unit are set forth on a HUD-approved rent schedule.

Project owners must remit excess rent (rental receipts in excess of each unit's basic rental rate) by the tenth day of the following month. Excess rent is calculated and reported on Form HUD-93104, "Monthly Report of Excess Income." The form must be submitted to HUD even when the project has no excess rent. Furthermore, tenant income certifications must be obtained even if the project is not subsidized.

On May 16, 2000, HUD issued Housing Notice 00-8, *Guidelines for Continuation of Interest Reduction Payments after Refinancing: "Decoupling", under Section 236(e)(2) and refinancing of insured Section 236 projects into non-insured Section 236(b) projects*. It establishes procedures for the optional continuation of interest reduction payment assistance when Section 236 projects are refinanced. Under the first option, the mortgage may be prepaid and the subsidies renewed if the project owner enters an agreement to maintain the affordability restrictions for five additional years beyond the term of the agreement. Under the second option, the subsidy is renewed if a state or local agency purchases the mortgage, terminates the FHA insurance, keeps the terms and conditions of the mortgage intact, and enters an agreement to maintain the affordability restrictions for five additional years beyond the term of the agreement.

## Section 241(a) Supplemental Loans for Multifamily Projects

Section 241(a) of the National Housing Act provides insured loans for additions, improvements, and repairs to apartment projects, nursing homes, hospitals, or group practice medical facilities that already carry HUD-insured or HUD-held loans. Major movable equipment for projects other than apartment projects and fire and safety equipment also may be included in the loan. Section 241(f) of the Act provides insurance for "equity loans," which allows owners to take out a portion of equity they have accumulated in the project. Only three projects with 944 units totaling \$6 million were insured by HUD under this program in fiscal year 2008.

## Section 242 Hospitals

Section 242 of the National Housing Act insures loans for the construction or rehabilitation of hospitals and the purchase of major movable equipment. Mortgage limits are basically 90% of the estimated replacement cost of the hospital, including equipment, and the maximum mortgage term is 25 years. Because of the increase in applications for mortgage insurance under Section 242, HUD issued revisions to the Hospital Mortgage Insurance Program in a Final Rule dated November 28, 2007. The purpose of the revisions was to add new provisions to make them consistent with industry practices.

## COINSURANCE PROGRAMS

In 1983, HUD began offering coinsured loans, thus giving lenders an alternative to full insurance. They served as a means of encouraging the new construction or rehabilitation of moderate income rental housing and residential

health care facilities. HUD's coinsurance programs were intended to function as risk-sharing arrangements between HUD and the private sector lenders. (Under the coinsurance programs, HUD insures 85% of the mortgage with the remaining 15% assumed by private sector mortgage companies; under HUD multifamily insurance programs, HUD insures 99% of the loan amount.) The coinsuring lenders assumed a portion of the insurance premium in return for their right to expedite processing of the loan.

Three coinsurance programs were authorized under Section 244 of the National Housing Act [as amended by Section 7(d) of the Department of Housing and Urban Development Act]:

- a. *Section 223(f) Coinsurance.* Section 223(f) coinsured loans were made for purchasing or refinancing of existing multifamily projects. Eligible projects included profit-motivated, limited distribution, and nonprofit projects. This was the most active coinsured loan program.
- b. *Section 221(d) Coinsurance.* Section 221(d) coinsured loans were made for new construction and substantial rehabilitation of rental housing. Eligible projects included profit-motivated, limited distribution, and nonprofit projects.
- c. *Section 232 Coinsurance.* Section 232 coinsured loans were made for new construction and substantial rehabilitation of nursing homes and certain residential health care facilities. Eligible projects included profit-motivated, limited distribution, and nonprofit projects.

Although the coinsurance programs made financing available to many multifamily housing projects, many owners and lenders were unable to honor their financial obligations, creating large losses for HUD. Accordingly, HUD terminated the coinsurance programs in regulations published in the October 10, 1990, *Federal Register*. Although coinsured loans are no longer made, HUD continues to service coinsured loans made before November 12, 1990, and coinsured loans to owners whose applications were in process but had not been approved as of that date.

## RISK-SHARING PROGRAM

Section 542 of the Housing and Community Development Act of 1992 (also called the Multifamily Housing Finance Improvement Act) authorized the creation of an insurance program to demonstrate the effectiveness of providing new forms of credit enhancement for multifamily loans. The resulting program, referred to as the multifamily risk-sharing program, is designed to encourage the production of affordable rental housing by allowing HUD to provide risk-sharing arrangements to state and local housing finance agencies (HFA). Qualified state and local housing finance agencies may originate and underwrite affordable housing loans including new construction, substantial rehabilitation, refinancing, and housing for the elderly. The program provides full FHA mortgage insurance to enhance HFA bonds to investment grade. Agencies may elect to share from 10% to 90% of the loss on a loan with HUD. In the event of a claim, the agency reimburses HUD pursuant to terms of the risk sharing agreement.

A housing finance agency must be approved by HUD to participate in this program. To be eligible, the agency must be a HUD-approved multifamily mortgagee in good standing and meet other credit, experience, and management criteria. In fiscal year 2008, HUD insured mortgages for 37 projects with 3,610 units, totaling \$238 million, under this program.

On March 27, 2000, HUD issued a final rule amending 24 CFR, Parts 5 and 266, titled *Uniform Financial Reporting Standards for HUD Housing Programs; Revised Report Filing Date; Final Rule*. It removes the housing finance agency risk-sharing program from the list of multifamily programs subject to the Uniform Financial Reporting Standards. Audited project financial statements are submitted to the applicable housing finance agency, which determines audit scope and the required financial information.

Regulations governing the program are found at 24 CFR 266.

## DIRECT LOANS, CAPITAL ADVANCES, FLEXIBLE SUBSIDIES, AND GRANTS

HUD programs for direct loans and grants focus on the following areas:

- a. Providing housing and supportive services for low and moderate income elderly persons (Section 202 direct loan and capital advance programs).
- b. Providing housing and supportive services for low and moderate income disabled persons (Section 811 capital advance program).
- c. Providing loans to multifamily projects subsidized under certain other HUD programs that need additional federal assistance to maintain future viability (flexible subsidies).
- d. Providing grants to nonprofit owners for conversion or capital improvements of housing for the elderly.

### Section 202 Direct Loans for Housing for the Elderly or Handicapped Persons

Section 202 of the Housing Act of 1959 provided low interest direct loans for the construction of housing for the exclusive use of persons age 62 or older and handicapped individuals. Section 202 loans were available only to nonprofit owners. In 1991, Congress replaced the Section 202 direct loan program with two new capital advance programs for the elderly and disabled persons. HUD continues to service direct loans that were made before termination of the program, however. Section 8 rent subsidies are available to most Section 202 direct loan program projects.

In August 2002, HUD issued Housing Notice 2002-16, *Revised Prepayment of Direct Loans and 202/8 Projects with Inclusion of FHA Mortgage Insurance Guidelines*. Housing Notice 2002-16 provides guidance on prepayment and refinancing of Section 202 direct loan projects and Section 202 direct loans with Section 8 project-based assistance (202/8), and sets forth the requirements for a narrowly defined limited partnership ownership entity that may acquire and operate the project after prepayment. Those changes further implement Subtitle C of Title VIII of Public Law 106-569, the "American Homeownership and Economic Opportunity Act of 2000." In substance, Housing Notice 2002-16 addresses several program changes, as follows:

- Reiterates prepayment option for HUD 202 direct loans for which the mortgage note merely requires a 30-day notice to HUD prior to prepayment.
- Creates a *prepayment* process for HUD 202 direct loans for which HUD approval for prepayment is required by the mortgage note.
- Expands the administrative restrictions regarding *acceptable project owners* to include a *for-profit limited partnership* as long as its sole general partner is the current project owner or a corporation wholly owned and controlled by the current owner.
- Describes the project-based Section 8 contract savings in the event of a reduced Section 8 contract.
- Assuming prepayment and refinancing pursuant to the Housing Notice, authorizes the use of a portion of the residual receipts account for a portion of new supportive services.
- Assuming prepayment and refinancing pursuant to the Housing Notice, authorizes the use of a portion of the replacement reserve for rehabilitation, modernization, or retrofitting of projects.
- Sets developer fee and return on equity limitations if the refinancing includes investment by virtue of the Low Income Housing Tax Credit Program.

Housing Notice H 04-21 amends certain underwriting provisions of Housing Notice 2002-16 and revises the maximum developer's fee and the limits on surplus cash distributions. Part IV of the notice caps the developer fee

at the lesser of 15% of total development costs [as defined by the respective state in its administration of the Low Income Housing Tax Credit Program [(LIHTC)], or the maximum fee allowed by the respective state LIHTC program. Part IV of Housing Notice H 04-21 also revises the maximum annual distribution from surplus cash at 6% of the owner's equity contributed at the refinancing of the project.

## Capital Advance Programs

**Section 202 Supportive Housing for the Elderly.** The 1991 Cranston-Gonzalez National Affordable Housing Act replaced the Section 202 direct loan program with a Section 202 capital advance program. The program makes capital advances to cooperatives and nonprofit owners of housing occupied by very low income households having at least one person age 62 or older. Capital advances are available to fund both the construction or rehabilitation of such housing. They bear no interest and need not be repaid so long as the owner continues to make the housing available for the elderly for at least 40 years. The owner is required to deposit 0.5% of the approved capital advance (up to a maximum deposit of \$25,000) in an escrow account to assure the owner's commitment to the housing. The housing must provide "supportive" services tailored to the needs of the elderly such as housekeeping, meals, and transportation.

The Cranston-Gonzalez Act also provides rental assistance for projects funded through Section 202 capital advances. (The former Section 202 direct loan program made rental subsidies available through Section 8.) Project rental assistance covers the difference between the amounts tenants pay and the HUD-approved operating costs per unit. (Project rental assistance does not include an amount for debt service.)

In September 2005, HUD published a final rule in the Federal Register titled *Mixed-Finance Development for Supportive Housing for the Elderly or Persons With Disabilities and Other Changes to 24 CFR Part 891* (the Rule). The Rule uses the mixed-financed development model to leverage the capital and expertise of the private developer community to create attractive and affordable supportive housing developments for the elderly or persons with disabilities. In addition, the rule is structured so that tax credits can be used to provide additional units as well as supplement capital advance funds for the Section 202 or 811 project.

**Section 811 Supportive Housing for Disabled Persons.** Section 811 of the Cranston-Gonzalez National Affordable Housing Act provides capital advances to nonprofit owners of housing occupied by disabled persons between the ages of 18 and 62. The Section 811 program operates much like the Section 202 capital advance program. Capital advances under Section 811 bear no interest and need not be repaid so long as the housing remains available for very low income disabled persons for at least 40 years. The owner is required to deposit 0.5% of the approved capital advance (up to a maximum deposit of \$10,000) in an escrow account. Similar to Section 202 capital advance projects, Section 811 projects provide supportive services for their disabled tenants. Project rental assistance covers the difference between operating costs per unit and the amount tenants pay.

## Flexible Subsidies

Section 201 of the Housing and Community Development Act of 1978 provides two types of Flexible Subsidy loans designed to restore and maintain the physical and financial soundness to multifamily projects subsidized under certain other HUD programs:

- a. *Operating Assistance Program (OAP)*—provides loans that may be used to (1) correct physical deficiencies in the project that violate local building codes or that are caused by deferring necessary maintenance, (2) correct operating or replacement reserve deficits, (3) make energy conservation improvements, or (4) make alterations to accommodate handicapped persons. OAP loans carry an interest rate of 1% and are repaid in accordance with HUD requirements.
- b. *Capital Improvement Loan Program (CILP)*—provides loans for major repairs and replacements of building components, including roofs, plumbing, air conditioners, and electrical systems. CILP loans carry an interest rate between 3% and 6% and are repaid through monthly payments.

Flexible subsidies are available to owners of rental or cooperative housing projects. Eligible projects include the following:

- a. Section 236 projects.

- b. Section 221(d)(3) Below Market Interest Rate projects.
- c. Section 202 projects that are 15 years old or more.
- d. Certain Section 8 rent subsidy projects.

### Grant Programs for Nonprofit Owners

**Assisted-living Conversion Program (ALCP).** This grant program allows nonprofit owners of eligible developments to convert some or all of the dwelling units in the project into an assisted living facility for the frail elderly. The ALCP provides funding for the costs of converting some or all of the units, common areas and services space.

Only private nonprofit owners of Section 202, Section 8 project-based (including Rural Housing Services' Section 515), Section 221(d)(3) BMIR, and Section 236 housing developments that are designated primarily for occupancy by the elderly for at least five years are eligible for funding under the ALCP. A private nonprofit owner of an unused or underutilized commercial property is also eligible.

**Emergency Capital Repair Program (ECRP).** This grant program provides grants for emergency capital repairs to nonprofit owners of eligible developments designated for occupancy by elderly tenants. The capital repairs must relate to items that present an immediate threat to the health, safety, and the quality of life of the tenants. The one-time grants are used for emergency items that could not be funded within the project's operating budget and other project resources.

Only private, nonprofit owners of Section 202 direct loan projects with or without Section 8 rental assistance; Section 202 capital advance projects receiving rental assistance under their Project Rental Assistance contract (PRAC); Section 515 rural housing projects receiving Section 8 rental assistance; projects subsidized with Section 221(d)(3) below-market interest mortgage; projects assisted under Section 236 of the National Housing Act; and other projects receiving Section 8 project-based rental assistance that are designated primarily for occupancy by the elderly are eligible. These projects must have had closing on or before January 1, 1999.

### Recovery Act Program

The American Recovery and Reinvestment Act of 2009 (Recovery Act) appropriated approximately \$250 million for grants and loans to certain owners of HUD-assisted projects under the Green Retrofit Program for Multifamily Housing. The grants and loans will be made to eligible property owners for energy and green retrofit investments in their projects. HUD-assisted projects that have already received assistance under any of the following programs are eligible:

- Section 202
- Section 811
- Section 8 rent subsidy programs

This program will be administered by HUD's Office of Affordable Housing Preservation (OAHP), which began accepting applications for the program on June 15, 2009. HUD Housing Notice 09-02, *Green Retrofit Program for Multifamily Housing*, issued May 13, 2009, provides guidance about how to apply for the program and information about program implementation. The Catalog of Federal Domestic Assistance (CFDA) number for this program is 14.318.

## RENT SUBSIDY PROGRAMS

### Summary of Program Provisions

HUD's rent subsidy programs provide housing assistance to low income families so that they are able to lease "decent, safe, and sanitary" housing. Under the programs, owners of eligible rental housing receive payments on



behalf of subsidized tenants for the difference between HUD-approved rental rates and rents determined by statute that low income tenants are obligated to pay. Most programs also allow additional amounts for utility allowances. Any type of rental housing may be eligible, including cooperatives, mobile homes, and housing for the elderly. Some of HUD's rent subsidy programs are "unit-based" (sometimes referred to as "project based") rather than "tenant-based." In other words, they provide financial assistance on behalf of qualified tenants who lease units in specific eligible projects. Others are tenant-based, however, and are provided on behalf of specific eligible tenants. Within program limits, those subsidies accompany the tenants, regardless of where they reside. Depending on the particular program, HUD may remit subsidy payments directly to project owners on behalf of qualified tenants, or HUD may contract with public housing authorities or other qualifying agencies to administer the program, including payments to project owners.

A Housing Assistance Payments Contract (HAP Contract) specifies the project owner's responsibilities under the rent subsidy program and regulates payments to project owners on behalf of subsidized tenants. If a public housing authority (PHA) participates in the program, an Annual Contributions Contract (ACC) between HUD and the PHA stipulates the housing authority's administrative responsibilities.

HUD's rent subsidy programs can be classified into the following categories:

- a. Section 8 (the largest HUD rent subsidy program).
- b. Rental Assistance Payments.
- c. Rent Supplement.
- d. Project Rental Assistance under the Section 202 and Section 811 capital advance programs.

## Section 8 Assistance Programs

Section 8 of the United States Housing Act of 1937 authorizes a number of rent subsidy programs, which are discussed in this lesson. The emphasis of Section 8 in recent years has shifted from new construction projects to existing housing. Section 8 assistance is a rental subsidy directed toward lower income families. Under the Section 8 programs, HUD provides owners of Section 8 housing (which may be either profit or nonprofit entities including cooperatives) with subsidies for the difference between a HUD-approved or "contract" rent for a unit (generally approximating a fair market rental rate for the units) and an amount determined by formula to be payable by the Section 8 tenant. The rent paid by the tenant is a percentage of tenant gross income subject to a \$25 minimum; it cannot exceed the largest of the following amounts: (a) 30% of the family's adjusted monthly income, (b) 10% of the family's monthly income, or (c) the "housing component" of welfare assistance paid to the tenant by the federal government or a state or local government. Owners generally also are eligible to receive partial subsidies for vacant Section 8 units.

Housing assistance payments are specified in the HAP contract. Owners request payments monthly by submitting an electronic version of Form HUD-52670.

Subtitle A of HUD's 1998 Appropriations Bill (HR 2158) provides for restructuring of Section 8 contracts for certain FHA-insured multifamily projects. This restructuring can include conversion from "unit-based" assistance to "tenant-based" assistance under the Section 8 Certificate and Section 8 Voucher programs as original HAP contracts expire.

For Section 8 projects that have individual unit utility meters and a separate tenant-paid utility allowance [also known as the Personal Benefit Expense (PBE)], HUD requires the project owner to adjust the PBE as part of an application for a rental increase or whenever a utility rate change would cause a cumulative increase of 10% or more in the most recently approved utility allowances. HUD field offices have issued reminder letters to project owners that Section 8 PBE adjustments are mandatory, especially in light of utility rate increases in certain geographical areas. In the situation where the Section 8 rent is *not increased*, and the PBE is *increased*, the project will experience a net decrease in receipts from the tenants' Section 8 subsidy.

**Section 8 New Construction and Substantial Rehabilitation.** The purpose of the Section 8 New Construction and Substantial Rehabilitation programs was to provide lower income families with decent, safe, and sanitary

housing. Congress repealed the authorization for Section 8 assistance to new construction and substantial rehabilitation projects (except for units produced under the Section 202 direct loan program) with the passage of the Housing and Urban-Rural Recovery Act of 1983. Accordingly, no new HAP contracts are being issued under the programs, but the federal government remains obligated to honor all existing HAP contracts issued under them. For both new construction and substantial rehabilitation programs, the term of the initial contract is a maximum of 20 years for insured loan projects and 40 years for uninsured projects.

Regulations governing the new construction program are found at 24 CFR 880; regulations governing the substantial rehabilitation program are found at 24 CFR 881.

**Section 8/Section 202.** Section 8 of the United States Housing Act of 1937 also provides rent subsidies to Section 202 direct loan program projects. The term of the initial HAP contract is 20 years. Assistance is limited to existing Section 202 direct loan projects because no new Section 202 direct loans are being made.

Regulations governing the program are found at 24 CFR 891.

**Tenant-based Assistance under the Section 8 Certificate and Section 8 Voucher Programs.** In April 1998, HUD completed the regulatory merger of tenant-based rental assistance under the rental certificate and the rental voucher programs. Both programs are available for families with incomes not exceeding 50% of the area's median income. The programs are administered by public housing authorities or equivalent agencies with funds received from HUD based on an Annual Contributions Contract (ACC). The ACC between HUD and the housing authority specifies the responsibilities of the housing authority, the funds it is eligible to receive from HUD for rental assistance, and the administrative fee earned. The housing authority then executes a HAP contract with the project owner selected by the tenant agreeing to make housing assistance payments to the owner on behalf of the tenant for the term of the tenant's lease.

The Section 8 voucher program currently includes several types of vouchers. Links to more detailed information about the voucher programs can be found at [www.hud.gov/offices/pih/programs/hcv/](http://www.hud.gov/offices/pih/programs/hcv/).

- Project-based vouchers encourage property owners to construct, rehabilitate, or make available existing housing units for lease to very low income families.
- Tenant-based vouchers enable very low income families to lease safe, decent, and affordable privately owned and rental housing.
- Conversion vouchers provide replacement housing and relocation assistance needed as a result of the demolition, disposition, or mandatory conversion of public housing units. Conversion vouchers are also provided to families affected by an owner's decision to opt-out of a project based Section 8 contract and families affected by an owner's decision to prepay a HUD issued mortgage.
- Family Unification vouchers enable families to rent affordable housing when the lack of affordable housing is a primary factor in separating children from their families or in preventing reuniting children with their families.
- Homeownership vouchers enable very low income families to purchase a home.
- Vouchers for people with disabilities enable very low income families with disabilities to lease affordable private housing.
- Welfare-to-Work vouchers assist families who make the transition from welfare to economic self-sufficiency.

The subsidy for the certificate program is the difference between the actual unit's rent and 30% of the tenant's adjusted monthly income. The subsidy for the voucher program is the difference between a payment standard (based on the HUD-published fair market rent—FMR) and 30% of the tenant's adjusted monthly income. Thus, a tenant under the voucher program may pay more or less than 30% of his or her income depending on the relationship between the unit's rent and the payment standard. The 1998 regulations create a third type of tenancy, the over-FMR certificate tenancy. For the over-FMR tenancy, the payment standard is equal to the FMR or exception



rent. The housing assistance payment is the lesser of (a) the payment standard minus the total tenant payment, or (b) the monthly gross rent minus the total tenant payment.

Both programs allow portability of benefits. In other words, tenants keep their benefits, regardless of where they live. Regulations governing the tenant-based certificate and voucher programs are found at 24 CFR 982.

**Section 8 Project-based Certificate Program.** In the project-based Section 8 Certificate program (sometimes called the “unit-based” Section 8 Certificate program), the public housing authority can designate rental assistance as project-based. Tenants receive a rent subsidy only while occupying a specific unit in the project.

Regulations governing the project-based certificate program are found at 24 CFR 983.

**Section 8 Moderate Rehabilitation.** This rent subsidy program also is targeted for very low income families with incomes not exceeding 50% of the median income for the area. Under the program, landlords agree to rehabilitate properties to meet certain safety and sanitation standards and apply to the housing authorities, who select the landlords based on a competitive process. Like the Section 8 Certificate and Section 8 Voucher programs, the program is administered through a local housing authority. Funds flow from HUD to the housing authority under the terms of the Annual Contributions Contract and from the housing authority to the landlord under a HAP contract. The term of the initial HAP contract is 15 years.

The Section 8 Moderate Rehabilitation program is inactive, and no new HAP contracts are available under it. Regulations governing the Section 8 Moderate Rehabilitation program are found at 24 CFR 882, subparts D and E.

**Section 8 Loan Management Set Aside Program.** The focus of the Loan Management Set Aside program (LMSA) is to assist HUD-insured projects that are experiencing financial difficulties. The purpose of the LMSA rent subsidy is to prevent project owners from defaulting on their HUD-insured loans, thus allowing HUD to reduce the number of insurance claims filed. LMSA is most often used to assist Section 236 and Section 221(d)(3) insured loan projects. The term of the initial assistance contract is a maximum of 15 years.

Regulations governing the program are found at 24 CFR 886, subpart A.

**Section 8 Property Disposition Program.** Under this program, the rent subsidies assist project owners who have purchased existing projects that HUD had previously acquired through foreclosure. Rent subsidies begin after the owner has made repairs necessary to bring the building back to standard. Many projects are former Section 236 and Section 221(d)(3) insured loan projects.

Regulations governing the program are found at 24 CFR 886, subpart C.

**Mark-to-Market Restructuring.** Some Section 8 projects are experiencing above market rents on their Section 8 contracts. Many current rental rates for HUD low-income projects exceed those charged for unregulated and unsubsidized housing of similar quality and location. To address this situation, HUD's Office of Affordable Housing Preservation (OAHP) established the mark-to-market restructuring program (M2M). To solve the issue of above market rents, an *eligible* project may opt out of the Section 8 program, choose to renew their contract with HUD (usually at reduced contract rents) without restructuring their debt (Lites program), or participate in the full restructuring M2M program. This discussion focuses on the full restructuring M2M program. Links to information on the M2M program, including the Lites program, can be found at [www.hud.gov/offices/hsg/omhar/readingrm/sitemap.cfm](http://www.hud.gov/offices/hsg/omhar/readingrm/sitemap.cfm).

The full restructuring M2M program involves restructuring debt on certain multifamily properties insured by FHA that have above market rents on their Section 8 contracts. The M2M program will either modify the original loan or pay off the existing mortgage in full prior to its maturity date. If the existing mortgage is paid in full, the owner signs a new mortgage-restructuring note.

The current FHA-insured loan is paid-in-full and replaced with—

- A new FHA-insured [223(a)(7)] loan [based on Participating Administrative Entities' (PAE) conclusion as to what the project will support given the new rent/expense structure],

- A new second mortgage, provided directly by HUD, and referred to as the Mortgage Restructuring Note (MRN), and, if necessary,
- A new third mortgage, provided directly by HUD, and referred to as the Contingent Repayment Note (CRN).

Additionally, the M2M program will reduce rents to market levels. With the reduced rents and restructured debt, the project should generate positive surplus cash, be able to pay incentive performance fees, increase reserve for replacements deposits, and generate distributable cash flow.

To be eligible for the M2M program, a project must meet the following requirements:

- Be in good physical condition.
- Not be on the list of ineligible properties.
- Have current Section 8 rents that exceed gross potential comparable marketable rents.
- Have a mortgage (or mortgages) insured or held by HUD with one or more expiring.
- Have Section 8 project-based assistance contracts.

Every project will be subject to affordability and use restrictions in a recorded Use Agreement. The Use Agreement generally is in effect for 30 years and contains various covenants. A typical M2M restructuring requires a capital advance from the owner to cover a portion of the transaction costs and costs of rehabilitation. These capital advances must come from surplus cash prior to restructuring and/or nonproject cash. The program provides for a capital recovery payment as provided in the restructuring plan. Payments are subject to monthly cash flow limitations. The M2M program provides for an incentive performance fee calculated at 3% of effective gross income, and it is payable on an annual basis from surplus cash. The incentive performance fee is discussed in chapter 3 of the HUD M2M Operating Procedures Guide, which is available at [www.hud.gov/offices/hsg/omhar/readingrm/opglinks.cfm](http://www.hud.gov/offices/hsg/omhar/readingrm/opglinks.cfm). Assuming surplus cash, and after the payment of the incentive performance fee, the owner may take 25% of the remaining surplus cash, with the balance available for payments on the mortgage restructuring note and the contingent repayment note.

### **Rental Assistance Payments (RAP)**

Section 221(f)(2) of the Housing and Community Development Act of 1974 established the Rental Assistance Payments (RAP) program. The program provides assistance payments to owners on behalf of very low income tenants and is piggybacked with the Section 236 Interest Reduction program. The length of the initial contract is a maximum of 40 years. Under the program, the tenant pays the greater of 30% of the tenant's adjusted income, 10% of gross income, or "welfare rent," that is, the "housing" portion of welfare payments received by the tenant.

Very few RAP projects exist today. Most owners have converted to Section 8 rent subsidies because they offer owners more favorable contract terms. Regulations governing the program are at 24 CFR 236, subpart D.

### **Rent Supplement**

The Rent Supplement program authorized rental assistance payments to be made to owners of Section 221(d)(3) BMIR, Section 236, and Section 202 projects. The subsidy is equal to the greater of 30% of the tenant's adjusted gross income or 30% of gross rent, subject to the cap under the original contract. Since HUD has no statutory authority to alter the original rental assistance contract and budget amount, the available assistance is limited to the original contract. The term of the initial contract is a maximum of 40 years.

There are very few remaining Rent Supplement program projects; most have converted to Section 8 rent subsidies. Regulations governing the program are found at 24 CFR 215.

**Project Rental Assistance for Section 202 and Section 811 Capital Advance Projects.** Project Rental Assistance is used in lieu of Section 8 rent assistance in the Section 202 and 811 capital advance programs. Project

Rental Assistance covers the difference between the HUD-approved operating cost per unit and the amount the tenant pays. The tenant pays the greater of (a) 30% of the tenant's adjusted monthly income, (b) 10% of the tenant's monthly income, or (c) the portion of the tenant's welfare assistance representing housing costs. Initially, the term of the Project Rental Assistance contracts were 40 years. However, more recent Project Rental Assistance contracts have initial terms of only five years.

Regulations governing Project Rental Assistance are found at 24 CFR 891.

### **Recovery Act Program**

The American Recovery and Reinvestment Act of 2009 (Recovery Act) appropriated approximately \$2 billion for the Section 8 Project-based Rental Assistance Program. As an incentive to project owners to stay in the Section 8 program, this appropriation provides a full 12 months of rental assistance payments for existing Section 8 contracts. This will avoid the payment disruptions that have occurred in recent years. No new awards are being made under this program.

### **Contract Extensions**

In January 2001, HUD issued the Section 8 Renewal Policy Guide Book, which provides guidance for renewing expiring Section 8 contracts. It replaces the previous process of issuing housing notices for individual changes in policy. The guide book is a comprehensive resource for all renewals and is updated periodically to reflect program and legislative changes. Links to the complete guide book and the latest transmittal of page changes to the book can be found at [www.hud.gov/offices/hsg/mfh/mfhsec8.cfm#s8rpg](http://www.hud.gov/offices/hsg/mfh/mfhsec8.cfm#s8rpg).



## SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Under HUD multifamily insurance programs, FHA insured loans are made by FHA-approved, private lending institutions to any of the following **except**:
  - a. Manufacturers of mobile homes.
  - b. Owners of rental housing projects.
  - c. Owners of condominiums.
  - d. Nursing homes.
2. Which of the following statements accurately describes the requirements a project must meet to be eligible for HUD insurance?
  - a. The project must always be located on real estate held in fee simple.
  - b. The property may be subject to minimal liens in addition to the insured mortgage.
  - c. Mortgage insurance is not required so long as project owners have permanent commitment of adequate construction and mortgage financing.
  - d. The project must be "economically feasible".
3. Which of the following statements is **not** representative of HUD-insured programs?
  - a. Tenant eligibility is based on tenant income.
  - b. Market conditions of each project determine maximum rent that can be charged.
  - c. The maximum rent must be adequate to service the mortgage.
4. Which section of the National Housing Act provides insured mortgages for refinancing of any HUD-insured nursing home?
  - a. Section 223(a)(7).
  - b. Section 223(f).
5. Which section of the National Housing Act insures loans to finance the construction or rehabilitation of rental housing for the elderly and handicapped?
  - a. Section 231.
  - b. Section 232.
6. Under Section 242 of the National Housing Act, mortgage limits are basically 90% of the estimated replacement cost of the hospital, including equipment, and the maximum mortgage term is:
  - a. 20 years.
  - b. 25 years.
  - c. 30 years.
  - d. 35 years.

7. Which of the following is **inaccurate** regarding the focus of HUD programs for direct loans and grants?
- a. Section 202 direct loan and capital advance programs.
  - b. Section 236 capital advance program.
  - c. Flexible subsidies.
  - d. Grants to nonprofit owners for conversion of housing for the elderly.
8. Section 202 of the Housing Act of 1959 established direct loans for which the mortgage note required a 30-day notice to HUD prior to prepayment. In August 2002, HUD issued Housing Notice 2002-16, *Revised Prepayment of Direct Loans and 202/8 Projects with Inclusion of FHA Mortgage Insurance Guidelines*. Under Housing Notice 2002-16, the mortgage note requires a \_\_\_\_\_ to HUD prior to prepayment.
- a. 30-day notice.
  - b. 60-day notice.
9. Capital advances to nonprofit owners of housing occupied by disabled persons between the ages of 18 and \_\_\_\_\_ are provided by Section 811 of the Cranston-Gonzalez National Affordable Housing Act.
- a. 62.
  - b. 65.
10. Which of the following loan programs carries an interest rate of 1%?
- a. Operating Assistance Program (OAP).
  - b. Capital Improvement Loan Program (CLIP).
11. Grants for emergency capital repairs to nonprofit owners of eligible developments designated for occupancy by elderly tenants is provided by the Emergency Capital Repair Program (ECRP). In order to qualify for this program, private nonprofit owners of eligible developments designated for occupancy by elderly tenants must have projects that had closing on or before:
- a. January 1, 2002.
  - b. January 1, 2001.
  - c. January 1, 2000.
  - d. January 1, 1999.
12. The rent paid by the tenant under a HUD Section 8 assistance program cannot exceed the largest of three amounts. Which of the following is one of those amounts?
- a. 25% of the family's adjusted monthly income.
  - b. 15% of the family's monthly income.
  - c. 20% of the family's gross annual income.
  - d. The "housing component" of welfare assistance paid to the tenant by the federal, state, or local government.

13. The term of the initial contract for both new construction and substantial rehabilitation programs is a maximum of \_\_\_\_\_ for uninsured loan projects.
  - a. 20 years.
  - b. 30 years.
  - c. 40 years.
  - d. 50 years.
14. Under the Section 8 voucher program, which of the following provides replacement housing and relocation assistance needed as a result of the demolition, disposition, or mandatory conversion of public housing units?
  - a. Family unification vouchers.
  - b. Conversion vouchers.
  - c. Tenant-based vouchers.
  - d. Project-based vouchers.
15. Regulations governing Section 8 Moderate Rehabilitation rent subsidy programs are found at:
  - a. 24 CFR 983.
  - b. 24 CFR 882, subparts D and E.
  - c. 24 CFR 886, subpart A.
  - d. 24 CFR 886, subpart C.
16. To be eligible for the mark-to-market (M2M) program, a project must meet a number of requirements. Which of the following requirements is accurate?
  - a. The project must be in tolerable physical condition.
  - b. The project must have current Section 8 rents less than gross potential comparable marketable rents.
  - c. The project must have a mortgage (or mortgages) insured or held by HUD with at least one expiring.
  - d. The project cannot have Section 8 project-based assistance contracts.
17. Initially, the term of the Project Rental Assistance contracts for Section 202 and Section 811 Capital Advance Projects was 40 years. More recent contracts have initial terms of:
  - a. 20 years.
  - b. 10 years.
  - c. 5 years.



## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Under HUD multifamily insurance programs, FHA insured loans are made by FHA-approved, private lending institutions to any of the following **except: (Page 102)**
  - a. **Manufacturers of mobile homes. [This answer is correct. Manufactured mobile homes do not qualify for FHA insured loans. However, owners seeking to construct or rehabilitate a mobile home park are eligible for HUD insurance programs.]**
  - b. Owners of rental housing projects. [This answer is incorrect. Owners of rental housing projects are one group eligible for FHA insured loans authorized by Title II of the National Housing Act of 1934.]
  - c. Owners of condominiums. [This answer is incorrect. FHA-approved private lending institutions can make FHA insured loans to owners of condominiums and housing cooperatives.]
  - d. Nursing homes. [This answer is incorrect. FHA insured loans are made by FHA-approved private lending institutions to hospitals, nursing homes, and health care facilities.]
2. Which of the following statements accurately describes the requirements a project must meet to be eligible for HUD insurance? **(Page 102)**
  - a. The project must always be located on real estate held in fee simple. [This answer is incorrect. In order to qualify for HUD insurance, the project must be located on real estate held in fee simple *or* subject to a lease meeting HUD criteria.]
  - b. The property may be subject to minimal liens in addition to the insured mortgage. [This answer is incorrect. The property must be free and clear of all liens other than the insured mortgage to qualify for HUD insurance.]
  - c. Mortgage insurance is not required so long as project owners have permanent commitment of adequate construction and mortgage financing. [This answer is incorrect. Project owners must have permanent commitment of adequate construction and mortgage financing, contingent only on approval of the project for mortgage insurance in order to be eligible for HUD insurance.]
  - d. **The project must be “economically feasible”. [This answer is correct. The project must be “economically feasible” as defined by HUD to be eligible for HUD insurance.]**
3. Which of the following statements is **not** representative of HUD-insured programs? **(Page 102)**
  - a. **Tenant eligibility is based on tenant income. [This answer is correct. Certain HUD-insured programs are designated for low and moderate income families; however, those programs do not determine tenant eligibility based on tenant income.]**
  - b. Market conditions of each project determine maximum rent that can be charged. [This answer is incorrect. The maximum rent that may be charged is tailored to the market conditions of each project.]
  - c. The maximum rent must be adequate to service the mortgage. [This answer is incorrect. The maximum rent must be adequate to service the mortgage, meet all project expenses, and provide project owners with a prescribed return on their investment.]

4. Which section of the National Housing Act provides insured mortgages for refinancing of any HUD-insured nursing home? **(Page 105)**
- a. **Section 223(a)(7). [This answer is correct. Section 223(a)(7) of the National Housing Act provides insured mortgages for refinancing of any HUD-insured multifamily project, including nursing homes.]**
  - b. Section 223(f). [This answer is incorrect. Section 223(f) of the National Housing Act provides insured loans to purchase or refinance existing projects requiring less than moderate rehabilitation to make them marketable under current conditions.]
5. Which section of the National Housing Act insures loans to finance the construction or rehabilitation of rental housing for the elderly and handicapped? **(Page 105)**
- a. **Section 231. [This answer is correct. Section 231 of the National Housing Act insures loans to finance the construction or rehabilitation of rental housing, at least half of which are occupied by persons age 62 or older and handicapped persons.]**
  - b. Section 232. [This answer is incorrect. Section 232 of the National Housing Act insures loans for financing the construction or renovation of nursing homes, intermediate care facilities, and board and care homes.]
6. Under Section 242 of the National Housing Act, mortgage limits are basically 90% of the estimated replacement cost of the hospital, including equipment, and the maximum mortgage term is: **(Page 106)**
- a. 20 years. [This answer is incorrect. Under Section 242, the maximum mortgage term is greater than 20 years.]
  - b. **25 years. [This answer is correct. Under Section 242, the maximum mortgage term is 25 years.]**
  - c. 30 years. [This answer is incorrect. Under Section 242, the maximum mortgage term is less than 30 years.]
  - d. 35 years. [This answer is incorrect. Under Section 242, the maximum mortgage term is less than 35 years.]
7. Which of the following is **inaccurate** regarding the focus of HUD programs for direct loans and grants? **(Page 108)**
- a. Section 202 direct loan and capital advance programs. [This answer is incorrect. HUD programs of direct loans and grants focus on Section 202 direct loan and capital advance programs that provide housing and supportive services for low and moderate income elderly persons.]
  - b. **Section 236 capital advance program. [This answer is correct. One area of focus by HUD programs of direct loans and grants is the Section 811 capital advance program that provides housing and supportive services for low and moderate income disabled persons. Section 236 covers the interest reduction program and insures loans for new construction and substantial rehabilitation.]**
  - c. Flexible subsidies. [This answer is incorrect. Flexible subsidies are one area of focus of HUD programs of direct loans and grants providing loans to multifamily projects subsidized under certain other HUD programs that need additional federal assistance to maintain future viability.]
  - d. Grants to nonprofit owners for conversion of housing for the elderly. [This answer is incorrect. HUD programs of direct loans and grants focus on a number of areas, one being the providing of grants to nonprofit owners for conversion or capital improvements of housing for the elderly.]

8. Section 202 of the Housing Act of 1959 established direct loans for which the mortgage note required a 30-day notice to HUD prior to prepayment. In August 2002, HUD issued Housing Notice 2002-16, *Revised Prepayment of Direct Loans and 202/8 Projects with Inclusion of FHA Mortgage Insurance Guidelines*. Under Housing Notice 2002-16, the mortgage note requires a \_\_\_\_\_ to HUD prior to prepayment. **(Page 108)**
- a. **30-day notice. [This answer is correct. Housing Notice 2002-16 reiterates the prepayment option for HUD Section 202 direct loans and retains a 30-day notice requirement to HUD prior to prepayment of the mortgage note.]**
  - b. 60-day notice. [This answer is incorrect. Housing Notice 2002-16 did not lengthen the mortgage note notice requirement to HUD prior to prepayment from what it was under Section 202 of the Housing Act of 1959.]
9. Capital advances to nonprofit owners of housing occupied by disabled persons between the ages of 18 and \_\_\_\_\_ are provided by Section 811 of the Cranston-Gonzalez National Affordable Housing Act. **(Page 109)**
- a. **62. [This answer is correct. Capital advances provided by Section 811 of the Cranston-Gonzalez National Affordable Housing Act are made to nonprofit owners of housing occupied by disabled persons between the ages of 18 and 62.]**
  - b. 65. [This answer is incorrect. Section 811 does *not* provide capital advances to nonprofit owners of housing occupied by disabled persons older than 62.]
10. Which of the following loan programs carries an interest rate of 1%? **(Page 109)**
- a. **Operating Assistance Program (OAP). [This answer is correct. OAP loans carry an interest rate of 1% and are repaid in accordance with HUD requirements. These types of loans can be used to make alterations to accommodate handicapped persons, make energy conservation improvements, correct operating or replacement reserve deficits, or to correct physical deficiencies in the project that violate local building codes or that are caused by deferring necessary maintenance.]**
  - b. Capital Improvement Loan Program (CLIP). [This answer is incorrect. CLIP loans carry an interest rate between 3% and 6% and are repaid through monthly payments. These types of loans can be used for major repairs and replacements of building components, including plumbing, air conditioners, electrical systems, and roofs.]
11. Grants for emergency capital repairs to nonprofit owners of eligible developments designated for occupancy by elderly tenants is provided by the Emergency Capital Repair Program (ECRP). In order to qualify for this program, private nonprofit owners of eligible developments designated for occupancy by elderly tenants must have projects that had closing on or before: **(Page 110)**
- a. January 1, 2002. [This answer is incorrect. Eligible projects must have had closing on or before a date earlier than January 1, 2002.]
  - b. January 1, 2001. [This answer is incorrect. The closing date for eligible projects must have been a date on or before a date that is earlier than January 1, 2001 in order to qualify for the ECRP Program.]
  - c. January 1, 2000. [This answer is incorrect. January 1, 2000 is after the cutoff date for eligible projects to have a closing date that qualifies for the ECRP program for emergency capital repairs.]
  - d. **January 1, 1999. [This answer is correct. In order to qualify for the ECRP, nonprofit owners eligible projects must have had closing on or before January 1, 1999.]**

12. The rent paid by the tenant under a HUD Section 8 assistance program cannot exceed the largest of three amounts. Which of the following is one of those amounts? **(Page 111)**
- a. 25% of the family's adjusted monthly income. [This answer is incorrect. The rent paid by the tenant under a HUD Section 8 assistance program cannot exceed the largest of three amounts. One of the three amounts is 30% of the family's adjusted monthly income.]
  - b. 15% of the family's monthly income. [This answer is incorrect. Another of the three amounts, the largest of which is the maximum amount of rent the tenant must pay under a HUD Section 8 assistance program is 10% of the family's monthly income.]
  - c. 20% of the family's gross annual income. [This answer is incorrect. The family's gross annual income is not one of the amounts to be considered when determining the maximum amount of rent the tenant must pay under a HUD Section 8 assistance program.]
  - d. The "housing component" of welfare assistance paid to the tenant by the federal, state, or local government. [This answer is correct. One of the three amounts, the largest of which being the rent amount the tenant must pay under a HUD Section 8 assistance program, is the "housing component" of welfare assistance paid to the tenant by the federal government or a state or local government.]**
13. The term of the initial contract for both new construction and substantial rehabilitation programs is a maximum of \_\_\_\_\_ for uninsured loan projects. **(Page 111)**
- a. 20 years. [This answer is incorrect. The term of the initial contract for both new construction and substantial rehabilitation programs is a maximum of 20 years for *insured* loan projects.]
  - b. 30 years. [This answer is incorrect. The term of the initial contract for both new construction and substantial rehabilitation programs is *not* 30 years for either insured or uninsured loan projects.]
  - c. 40 years. [This answer is correct. 40 years is the term of the initial contract for both new construction and substantial rehabilitation programs for uninsured loan projects.]**
  - d. 50 years. [This answer is incorrect. Neither insured nor uninsured loan projects carry a term of the initial contract that is as long as 50 years.]
14. Under the Section 8 voucher program, which of the following provides replacement housing and relocation assistance needed as a result of the demolition, disposition, or mandatory conversion of public housing units? **(Page 112)**
- a. Family unification vouchers. [This answer is incorrect. Family unification vouchers enable families to rent affordable housing when the lack of affordable housing is a basic factor in separating children from their families or in preventing reuniting children with their families.]
  - b. Conversion vouchers. [This answer is correct. Replacement housing and relocation assistance needed as a result of the demolition, disposition, or mandatory conversion of public housing units is provided by conversion vouchers. Conversion vouchers are also provided to families impacted by an owner's decision to opt-out of a project based Section 8 contract as well as to families affected by an owner's decision to prepay a HUD issued mortgage.]**
  - c. Tenant-based vouchers. [This answer is incorrect. Tenant-based vouchers make it possible for very low income families to lease safe, decent, and affordable privately owned and rental housing.]
  - d. Project-based vouchers. [This answer is incorrect. Project-based vouchers provide an incentive to property owners to construct, rehabilitate, or make available existing housing units for lease to very low income families.]

15. Regulations governing Section 8 Moderate Rehabilitation rent subsidy programs are found at: **(Page 113)**
- a. 24 CFR 983. [This answer is incorrect. Regulations governing the Section Project-based Certificate Program are found at 24 CFR 983.]
  - b. 24 CFR 882, subparts D and E. [This answer is correct. 24 CFR 882, subparts D and E, contain regulations governing the Section 8 Moderate Rehabilitation program. It should be noted that the Section 8 Moderate Rehabilitation program is inactive, and no new Housing Assistance Payments (HAP) contracts are available under it.]**
  - c. 24 CFR 886, subpart A. [This answer is incorrect. Regulations governing the Section 8 Loan Management Set Aside Program are found at 24 CFR 886, subpart A.]
  - d. 24 CFR 886, subpart C. [This answer is incorrect. Regulations governing the Section 8 Property Disposition Program are found at 24 CFR 886, subpart C.]
16. To be eligible for the mark-to-market (M2M) program, a project must meet a number of requirements. Which of the following requirements is accurate? **(Page 114)**
- a. The project must be in tolerable physical condition. [This answer is incorrect. To be eligible for the M2M program, a project must be in *good* physical condition.]
  - b. The project must have current Section 8 rents less than gross potential comparable marketable rents. [This answer is incorrect. A project must have current Section 8 rents that *exceed* gross potential comparable marketable rents in order to be eligible for the M2M program.]
  - c. The project must have a mortgage (or mortgages) insured or held by HUD with at least one expiring. [This answer is correct. In order to qualify for the M2M program, a project must have a mortgage (or mortgages) insured or held by HUD with one or more expiring.]**
  - d. The project cannot have Section 8 project-based assistance contracts. [This answer is incorrect. A project must have Section 8 project-based assistance contracts to meet eligibility requirements for the M2M program.]
17. Initially, the term of the Project Rental Assistance contracts for Section 202 and Section 811 Capital Advance Projects was 40 years. More recent contracts have initial terms of: **(Page 115)**
- a. 20 years. [This answer is incorrect. Recent Project Rental Assistance contracts do not have initial terms as long as 20 years.]
  - b. 10 years. [This answer is incorrect. Initial terms of recent Project Rental Assistance contracts are not for a period of 10 years.]
  - c. 5 years. [This answer is correct. More recent Project Rental Assistance contracts have initial terms that are only five years in duration.]**

## GENERAL CONTRACTS AND FORMS

The HUD forms discussed below, as well as many other HUD forms, may be obtained from HUD's website at [www.hud.gov/offices/adm/hudclips/forms](http://www.hud.gov/offices/adm/hudclips/forms).

### The Regulatory Agreement

HUD exercises control over the project through the regulatory agreement. The agreement is signed by HUD and the project owner and addresses the following areas:

- a. Owner's administrative duties and bookkeeping responsibilities.
- b. Owner's duty to maintain security deposit accounts, reserve for replacement funds, and residual receipts.
- c. Owner's right to make additions to the property.
- d. In the case of rent subsidized projects, tenant application, eligibility, and income certification procedures to be followed by the owner.
- e. No discrimination against families with children.
- f. No substitution of any general partner or management agent without HUD approval.
- g. No sale or conveyance of property without HUD approval.
- h. No distributions, except to the extent of surplus cash, and only under specific conditions.
- i. Prohibition against the owner's charging initial applicants more than one month's rent plus a security deposit.
- j. Project owner's duty to maintain property in good repair and condition.
- k. Records maintenance requirement and 60-day filing requirement for annual audit.
- l. Requirement to deposit project receipts in a federally insured financial institution.
- m. Agreement to comply with civil rights statutes.

Regulatory agreements are contained in the Form HUD-92466 series of forms, which are available from HUDCLIPS at [www.hudclips.org](http://www.hudclips.org).

### Affirmative Fair Housing Marketing Plan (Form HUD-935.2A)

HUD regulations require project owners to market their properties without regard to the race, color, religion, sex, or national origin of prospective tenants. An "Affirmative Fair Housing Marketing Plan" (Form HUD-935.2A), prepared by the owner and approved by HUD, describes the methods used to market the project, for example, classified ads, and includes the owner's promise to make special efforts to attract tenants who are least likely to apply for the housing.

Auditors should obtain a copy of the project's HUD-approved "Affirmative Fair Housing Marketing Plan" and be familiar with its contents.

### Management Entity Profile (Form HUD-9832)

"Management Entity Profile" (Form HUD-9832) must be completed by the management agent and submitted to the HUD field office. The document describes the management agent's ownership structure, operating procedures,



and the types of HUD projects it manages. A new profile must be submitted whenever there have been significant changes in the agent's organization or operations.

If the management agent has an *identity-of-interest* relationship with a HUD project owner, that fact must be disclosed in the Management Entity Profile. The profile should also disclose *identity-of-interest* relationships between the owner and *subcontractors*—firms that have contracted with the management agent to provide services to the project. According to HUD Handbook 4381.5 REV-1, Paragraph 2-3, an identity-of-interest relationship exists—

WHEN	IS ALSO
the owner or general partner of the owner	an owner, general partner, officer, or director of
or	(a) the management company or (b) a <i>subcon-</i>
any officer or director of the owner	<i>tractor</i> who has contracted with the management
or	agent to provide services to the project.
any person who directly or indirectly controls	or
10% or more of the voting rights or owns 10%	an individual, partnership, or corporation that
or more of the owner	directly or indirectly controls (a) 10% or more of
	the management agent's (or subcontractor's)
	voting rights or (b) 10% or more of the manage-
	ment agent (or subcontractor).

## Management Certifications

**Projects with Management Agents.** Form HUD-9839-B, "Project Owner's/Management Agent's Certification for Multifamily Housing Projects for Identity-of-Interest or Independent Management Agents," is submitted by projects that use management agents. The document specifies the duties the management agent is to perform for the project and fees paid to the management agent.

**Projects without Management Agents.** Generally, if the project does not use a management agent, it must file Form HUD-9839-A, "Project Owner's Certification for Owner-Managed Multifamily Housing Projects." If the project is for the elderly and is managed by a "project administrator" (i.e., a salaried employee of the owner), the project files Form HUD-9839-C, "Project Owner's/Borrower's Certification for Elderly Housing Projects Managed by Administrators."

## Computation of Surplus Cash, Distributions, and Residual Receipts

**Profit-motivated versus Limited Distribution and Nonprofit Projects.** Distributions to project owners are based on a Computation of Surplus Cash, Distributions and Residual Receipts. The amount of the distribution depends on whether the project is a profit-motivated, limited distribution, or a nonprofit project. Thus, the term *distribution* is used according to this regulatory context in the following discussion. In the case of profit-motivated projects, all surplus cash is available for distribution to project owners. However, it should be noted that the term *surplus cash* has a specific definition for a HUD project, and HUD regulations determine how surplus cash is calculated. In the case of limited distribution projects, distributions are limited to a maximum of either 6% or 10% of the owners' initial equity investment (as defined by HUD). If the project is a nonprofit project, distributions are not permitted, and all surplus cash must be deposited in a residual receipts account.

Exhibit 1-1 presents general guidelines for determining the amount of distributions to project owners.



# Exhibit 1-1

## Guidelines for Determining Distributions to Owners of Multifamily Housing Projects<sup>a, b</sup>

Type of Project	Distribution Earned
1. Section 8 New Construction projects whose notification of selection was issued on or after 11/5/79 and Section 8 Substantial Rehabilitation projects whose notification of selection was issued on or after 2/20/80:	
a. Nonprofit projects	No distribution permitted
b. Projects with less than 50 units	Surplus cash
c. Elderly projects	6% of initial equity investment (as defined by HUD)
d. Non-elderly projects	10% of initial equity investment (as defined by HUD)
2. Section 8 New Construction projects whose notification of selection was issued before 11/5/79 and Section 8 Substantial Rehabilitation projects whose notification of selection was issued before 2/20/80.	Surplus cash
3. Flexible Subsidy projects with operating assistance loans.	Distribution permitted except in (a) any year in which a project receives operating assistance or (b) the year following the operating assistance.
4. Other projects:	
a. Profit-motivated projects	Surplus cash
b. Limited distribution projects	6% of initial equity investment (as defined by HUD) <sup>c</sup>
c. Nonprofit projects	No distribution permitted

### Notes:

- <sup>a</sup> SOURCE: Adapted from HUD Handbook 4370.2 REV-1 CHG-1, *Financial Operations and Accounting Procedures for Insured Multifamily Projects*, pages 2-14.
- <sup>b</sup> This exhibit outlines the general guidelines for determining distributions to owners of HUD multifamily housing projects. The regulatory agreement or implementing regulations for the HAP contract will specify exactly how distributions are calculated for a particular project.
- <sup>c</sup> Limited distribution projects with Section 8 contracts processed under the Mark-To-Market program may have additional distributions in accordance with Chapter NO TAG of the M2M Program Operating Procedures Guide.

\* \* \*

The following additional rules apply to distributions:

- a. If surplus cash exceeds the allowable distribution and all cumulative distributions have been paid, the regulatory agreement requires that the excess be deposited into a residual receipts account.

- b. Distributions are not permitted if the project is in default under the regulatory agreement or note, or if it is under a forbearance agreement.
- c. Distributions may not be made from borrowed funds.
- d. Distributions may not be made until all required cost certifications have been submitted to HUD.
- e. Section 8 New Construction and Substantial Rehabilitation projects generally are allowed to pay distributions annually. Other projects that are eligible to pay distributions may make distributions semiannually.

**Calculating Distributions.** Surplus cash available for distribution consists of the following:

- a. Cash reported in the balance sheet.

*plus*

- b. Certain project receivables, as defined by HUD. For example, accounts receivable from HUD on tenant subsidy vouchers are included in the calculation of the project's surplus cash available for distribution.

*less*

- c. Certain project obligations, as defined by HUD. For example, accounts payable due within 30 days and accrued interest payable are generally included as current project obligations.

Although the surplus cash calculation is not conceptually difficult, errors may occur due to misunderstanding or incorrectly applying the applicable rules. A careful review of HUD's instructions for the surplus cash calculation provided in HUD Handbook 4370.2 REV-1 CHG-1 is recommended when auditors are testing the calculation. The following points may also prove useful:

- Surplus cash is calculated at the project level, not the entity level. Thus, partnership (or corporation) bank accounts are excluded from the computation. Separate construction bank accounts (HUD account 1121) are also excluded from the surplus cash calculation.
- Account S1300-030, "Other," may include certain receivables such as:
  - Approved withdrawals from the reserve for replacements that have not been received.
  - Medicare or Medicaid receivables expected to be collected within 60 days.
  - Interest Reduction Program (IRP) receivables. (Applies only to Section 236 projects.)

However, tenant receivables, insurance proceeds receivable, escrow deposits, and amounts due from related parties cannot be included in the calculation of surplus cash.

- The supplemental data account S1300-060, "Delinquent mortgage principal payments," should equal the sum of the required principal payments reported in account S1000-010, less the amount reported as principal payments on the statement of cash flows as reported in account S1200-360.
- The supplemental data account S1300-070, "Delinquent deposits to reserve for replacement," should equal the sum of the required deposits reported in account S1000-020, less total deposits made as reported in account 1320DT, unless deposits have been waived and indicated as such in account 1320R.
- Amounts reported in supplemental data account S1300-075, "Accounts payable—30 days," should not include entity-level payables. Also, any project construction or development payables should be excluded.
- The supplemental data account S1300-080, "Loans and notes payable (due within 30 days)," should be populated only with notes approved by HUD to be paid out of project operations. Mortgage principal

payments, loans or notes payable out of surplus cash, and owner advances should not be reported in this account.

- The supplemental data account S1300-090, "Deficit escrow deposits," should match the project's escrow analysis, excluding liabilities for unpaid taxes and insurance.
- Accrued expenses expected to be paid within 30 days are reported in the supplemental data account S1300-100, "Accrued expenses not escrowed." Entity-level and construction liabilities should be excluded from this account.
- "Other current obligations," supplemental data account S1300-110, can include bank overdrafts, other payables or accrued expenses, unexpended reserve for replacements withdrawals or insurance proceeds, and delinquent residual receipts deposits. Owner advances and entity-level and construction liabilities should be excluded from this account.
- For projects with commercial mortgage debt (i.e., non-HUD-regulated debt), the authors believe that balances in account 2131, "Accrued Interest Payable—First Mortgage (or Bonds)," should not be included in the surplus cash calculation inasmuch as there is no regulatory control that extends to the mortgage obligation. As a result, such amounts would not be reported in the supplemental data account S1300-050, "Accrued mortgage interest payable." The commercial loan agreement will require payment of the mortgage (including related interest) prior to the distribution of surplus cash. Other HUD professionals believe that account 2131 should be included.
- Inappropriate uses of project cash may be indicated by increases in certain asset accounts and decreases in certain liability accounts. The annual changes in those accounts due to outflows of project cash should not be more than cash eligible for distribution according to the surplus cash calculation. Otherwise, this cash outflow may be considered an unallowable distribution by HUD. Some of the accounts that may indicate this situation are:
  - Increases in the asset accounts 1140, "Accounts and Notes Receivable—Operations," and 1145, "Accounts and Notes Receivable—Entity."
  - Decreases in the liability accounts 2111, "Accounts Payable—Construction/Development;" 2113, "Accounts Payable—Entity;" 2132, "Accrued Interest Payable—Other Mortgages;" 2133, "Accrued Interest Payable—Other Loans and Notes (Surplus Cash);" 2172, "Other Mortgages Payable (Short Term);" 2173, "Other Loans and Notes Payable—Surplus Cash (Short Term);" 2305, "Accounts Payable—Entity (Long Term);" 2310, "Notes Payable (Long Term);" 2311, "Notes Payable—Surplus Cash;" 2322, "Other Mortgages Payable (Long Term);" and 2323, "Other Loans and Notes Payable—Surplus Cash."

Excess surplus cash remaining after payment of the distribution is deposited in the residual receipts account. If the amount of the distribution paid is more than the surplus cash calculation, HUD may determine that an unauthorized distribution has been made. This could occur if the amount of surplus cash available for distribution was estimated and paid based on incomplete or incorrect data. Unallowable distributions should be reported as questioned costs in the "Schedule of Findings and Questioned Costs" and may indicate an internal control deficiency.

## Management Reviews

HUD field offices periodically evaluate the performance of the project's management, that is, project owners and their management agents, if applicable. Form HUD-9834, "Management Review for Multifamily Housing Projects" is used for that purpose. The significant features of the form from the auditors' standpoint are:

- a. *Financial Management/Procurement* (Part D of Form HUD-9834) which contains HUD's assessment of management's accounting procedures and cash controls and the adequacy of the project's reserves.
- b. *Leasing and Occupancy* (Part E of Form HUD-9834) which contains HUD's assessment of management's procedures for selecting tenants and billing HUD for rent subsidy payments.

## CONTRACTS, FORMS, AND PROCESSES UNIQUE TO RENT SUBSIDY PROJECTS

The HUD forms discussed in this lesson, as well as many other HUD forms, may be obtained from HUD's website at [www.hud.gov/offices/adm/hudclips/forms](http://www.hud.gov/offices/adm/hudclips/forms).

### The Housing Assistance Payments (HAP) Contract

The HAP contract sets forth the rights and duties of the project owner and the contract administrator. The HAP contract provides the following:

- a. Agreement to market units in accordance with the Affirmative Fair Housing Marketing Plan and the regulations relating to fair housing advertising.
- b. Agreement to process applications and admit tenants only in accordance with HUD requirements.
- c. Agreement to provide decent, safe, and sanitary housing.
- d. Agreement to maintain an appropriate level of flood insurance.
- e. Agreement to comply with the requirements of the Clean Air Act and the Federal Water Pollution Control Act, if applicable.
- f. Agreement to abide by nondiscrimination requirements, including Section 504 of the Rehabilitation Act of 1973 and the Age Discrimination Act of 1975.
- g. Procedures for the owner to bill HUD for rent subsidies.
- h. Rules governing payments of rent subsidies to project owners.
- i. Number of units that HUD agrees to assist.
- j. Procedures for adjusting rents over the term of the HAP contract.
- k. Rules for paying owners for vacant units.

Most HAP contracts have an initial term of no more than 15 to 20 years. Subsequent contracts are usually renewed annually, subject to approval by HUD.

### The Rental Housing Integrity Improvement Project

HUD has identified three sources of errors contributing to improper rent subsidy payments as follows:

- Incorrect subsidy determinations by program administrators.
- Unreported tenant income.
- Incorrect billing or distribution of subsidy payments.

To assess the magnitude and reasons for these errors, HUD established the Rental Housing Integrity Improvement Project (RHIIP). The goal of RHIIP is to ensure that the "right benefits go to the right persons" and to improve the quality and accessibility of subsidized housing for families that need it the most. In recognition of HUD's efforts to provide improved guidance, training, automated systems support, and development of the Enterprise Income Verification (EIV) System through RHIIP, HUD's rental housing assistance programs were removed from the Government Accountability Office's "high risk" list in 2007.

The EIV system is a web-based system that allows users to obtain income data on potential and existing tenants. HUD makes monthly benefits data from the Social Security Administration (SSA). Also, monthly employer new hires (W-4), quarterly wage for federal and non-federal employees, and quarterly unemployment data from the Department of Health and Human Services' (HHS) National Directory of New Hires (NDNH) are available in EIV. Project owners and their management agents were encouraged to verify the income reported by tenants during annual and interim recertifications using the EIV since it was established in 2001. On January 27, 2009, HUD published a final rule in the Federal Register titled *Refinement of Income and Rent Determination Requirements in Public and Assisted Housing Programs*. This rule revised HUD's assisted housing program regulations to require the use of EIV by project owners and management agents for tenants' initial applications and recertifications, effective September 30, 2009. More information about RHIIP can be found on its website at [www.hud.gov/offices/hsg/mfh/rhiip/eiv/eivhome.cfm](http://www.hud.gov/offices/hsg/mfh/rhiip/eiv/eivhome.cfm).

### **Tenant Rental Assistance Certification System (TRACS)**

HUD developed TRACS to improve financial controls over certain multifamily housing programs. The system automates the procedures associated with applying for and certifying eligibility for rental subsidy programs. The basis for electronic submissions to TRACS is the Form HUD-50059, "Owner's Certification of Compliance with HUD's Tenant Eligibility and Rent Procedures," and the Form HUD-52670, "Housing Owner's Certification and Application for Housing Assistance Payments." Most multifamily projects subsidized by HUD are required to transmit the required data to TRACS electronically. HUD Handbook 4350.3 REV-1, *Occupancy Requirements of Subsidized Multifamily Housing Programs*, provides detailed guidance about submission requirements.

Form HUD-50059 is used by the owner to certify that the tenant is eligible for rental assistance. It is also used to calculate the portion of total rent to be paid by HUD and by the tenant. A separate Form HUD-50059 is prepared for each tenant, although the paper form is not actually filed with HUD. The specified data elements in Form HUD-50059 for each tenant are filed by the owner electronically to TRACS. However, HUD Handbook 4350.3 REV-1 requires that a copy of Form HUD-50059 is signed by and provided to the tenant and retained in the tenant's file. The auditor should determine that the owner's tenant files include the required documentation of the tenant income certifications transmitted to HUD.

Owners use Data Form HUD-52670 to bill the contract administrator for tenant assistance payments. The owner also may use this form to request reimbursement from HUD for vacancies and tenant damages. Form HUD-52670 is also filed electronically either directly to HUD through TRACS or to the project owner's Contract Administrator, if there is one. Rental Assistance Payment (RAP) and Rent Supplement projects must submit Form HUD-52670 by the 10th day of the voucher payment month. Projects receiving other HUD assistance, such as Section 8 projects, must submit Form HUD-52670 by the 10th day of the month before the month for which the payments are earned. For example, May 10th is the deadline for billing HUD for the June rent subsidy. Appendix 9 of HUD Handbook 4350.3 REV-1 provides detailed guidance about submission requirements.

Change 3 to HUD Handbook 4350.3 was released in July 2009. The majority of the changes in the handbook were corrections or clarifications. Some of the more significant changes include guidance for implementing Form HUD-50059-A, "Owner's Certification of Compliance with HUD's Tenant Eligibility and Rent Procedures—Partial Certification," and clarification about the amount of assistance the owner must repay if the annual recertification is not submitted to HUD within 15 months of the previous year's recertification date.

On February 25, 2009, HUD published a final rule in the Federal Register titled *Privacy Act of 1974; Notice of a Computer Matching Program Between the Department of Housing and Urban Development (HUD) and the Department of Health and Human Services (HHS): Matching Tenant Data in Assisted Housing Programs*. Further, on March 11, 2009, HUD published a related final rule in the Federal Register titled *Privacy Act of 1974; Notice of a Computer Matching Program Between the Department of Housing and Urban Development (HUD) and the Social Security Administration (SSA): Matching Tenant Data in Assisted Housing Programs*. These rules describe HUD's new computer matching programs with HHS and the SSA whereby HUD provides certain tenant data from TRACS to those agencies which then look for matches within their databases. The programs are designed with the objectives of verifying the income of individuals participating in rental assistance programs and detecting and reducing fraud and abuse in those programs. For example, if there is a match between data in TRACS and the SSA database that indicates a tenant is receiving Social Security (SS) or Supplemental Security Income (SSI) benefits, the tenant will

be required to provide current benefit information so that eligibility for rental assistance can be checked and verified. The final rule published on March 11, 2009, indicates HUD will make the SSA data available to auditors of HUD-assisted projects. More information about TRACS, including how to obtain access to the system, is available on the HUD website at <http://www.hud.gov/offices/hsg/mfh/trx/trxsum.cfm>.

**Rent Schedule—Low Rent Housing (Form HUD-92458)**

Owners use this form when requesting that HUD approve rent increases.

**Monthly Report of Excess Income (Form HUD-93104)**

Owners of Section 236 projects use Form HUD-93104 to calculate rents collected that are in excess of basic rents, which are payable to HUD.

**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

18. Of the following forms, which one describes the management agent's ownership structure, operating procedures, and the types of HUD projects it manages?
  - a. Form HUD-935.2A.
  - b. Form HUD-9832.
  - c. Form HUD-9839-A.
19. When testing the surplus cash calculation, Account S1300-030, "Other", may include certain receivables including Medicare or Medicaid receivables expected to be collected within:
  - a. 60 days.
  - b. 120 days.
20. Owners of multifamily housing projects that qualify for rent subsidy assistance use Form HUD-92458 in which of the following circumstances?
  - a. To certify that the tenant is eligible for rental assistance.
  - b. To calculate the portion of total rent to be paid by HUD and the tenant.
  - c. When requesting that HUD approve rent increases.
  - d. To calculate rents collected that are in excess of basic rents, which are payable to HUD.



## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

18. Of the following forms, which one describes the management agent's ownership structure, operating procedures, and the types of HUD projects it manages? **(Page 125)**
  - a. Form HUD-935.2A. [This answer is incorrect. Form HUD-935.2A describes the methods used to market the project and includes the owner's promise to work to attract tenants who are least likely to apply for the housing.]
  - b. Form HUD-9832. [This answer is correct. Form HUD-9832 must be completed by the management agent and include the management agent's ownership structure, operating procedures, as well as the types of HUD projects it manages. When there have been significant changes in the agent's organization or operations, a new profile must be submitted.]**
  - c. Form HUD-9839-A. [This answer is incorrect. Form HUD-9839-A must be filed if the project does not use a management agent.]
19. When testing the surplus cash calculation, Account S1300-030, "Other", may include certain receivables including Medicare or Medicaid receivables expected to be collected within: **(Page 128)**
  - a. 60 days. [This answer is correct. Account S1300-030, "Other", may include Medicare or Medicaid receivables that are expected to be collected within 60 days.]**
  - b. 120 days. [This answer is incorrect. Medicare or Medicaid receivables must be expected to be collected within a period of time that is less than 120 days in order to be included in Account S1300-030 when testing the surplus cash calculation.]
20. Owners of multifamily housing projects that qualify for rent subsidy assistance use Form HUD-92458 in which of the following circumstances? **(Page 132)**
  - a. To certify that the tenant is eligible for rental assistance. [This answer is incorrect. Form HUD-50059 has two purposes. One purpose is for owners of multifamily housing projects that qualify for rent subsidy assistance to certify that the tenant is eligible for rental assistance.]
  - b. To calculate the portion of total rent to be paid by HUD and the tenant. [This answer is incorrect. Form HUD-50059 has two purposes. One purpose is for the owner to calculate the portion of total rent to be paid by HUD and by the tenant.]
  - c. When requesting that HUD approve rent increases. [This answer is correct. Owners use Form HUD-92458 when a request for approval of rent increases is submitted to HUD.]**
  - d. To calculate rents collected that are in excess of basic rents, which are payable to HUD. [This answer is incorrect. HUD-93104 is used by owners of Section 236 projects to calculate rents collected that are in excess of basic rents, that are payable to HUD.]

**EXAMINATION FOR CPE CREDIT****Lesson 1 (HUDTG092)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. In accordance with HUD's multifamily insurance programs, leases may **not** be executed for a period less than:
  - a. 30 days.
  - b. 60 days.
  - c. 90 days.
  - d. 120 days.
2. HUD insures up to \_\_\_\_\_ of the approved mortgage amount for projects owned by nonprofit or cooperative owners.
  - a. 75%.
  - b. 80%.
  - c. 90%.
  - d. 100%.
3. HUD insures up to what percent of replacement cost for profit-motivated owners of Section 221(d)(3) projects?
  - a. 80%.
  - b. 85%.
  - c. 90%.
  - d. 95%.
4. For projects to be acquired under Section 223(f), the mortgage term generally cannot be less than \_\_\_\_\_ nor greater than \_\_\_\_\_.
  - a. 5 years; 15 years.
  - b. 10 years; 20 years.
  - c. 10 years; 30 years.
  - d. 10 years; 35 years.
5. Section 242 of the National Housing Act insures loans for the construction or rehabilitation of hospitals and the purchase of major movable equipment that meet certain specified criteria. Hospital ABC requires a mortgage covering 95% of the estimated replacement cost of the hospital only. Hospital DEF requires a mortgage of 95% of the estimated replacement cost of the hospital, including equipment. Hospital GHI requires a mortgage term of 30 years. Hospital JKL requires a mortgage term of 25 years. Which hospital has a requirement that qualifies it for an insured loan under Section 242?
  - a. Hospital ABC.
  - b. Hospital DEF.

- c. Hospital GHI.
  - d. Hospital JKL.
6. Under coinsured loans offered by HUD since 1983, HUD insures \_\_\_\_\_ of the mortgage and the remaining \_\_\_\_\_ is assumed by private sector mortgage companies.
- a. 75%; 25%.
  - b. 80%; 20%.
  - c. 85%; 15%.
  - d. 90%; 10%.
7. A Section 202 capital advance program, established by the 1991 Cranston-Gonzalez National Affordable Housing Act, makes capital advances to cooperatives and nonprofit owners of housing occupied by very low income households that have at least one person age 62 or older. The owner is required to deposit 0.5% of the approved capital advance, up to a maximum deposit of:
- a. \$20,000.
  - b. \$25,000.
  - c. \$30,000.
  - d. \$35,000.
8. Owners of rental or cooperative housing projects are potentially eligible for flexible subsidies. Which of the following projects would **not** be qualified for flexible subsidies?
- a. Section 236 projects.
  - b. Section 221(d)(3) Below Market Interest Rate projects.
  - c. Section 202 projects that are 10 years old or more.
  - d. Certain Section 8 rent subsidy projects.
9. Which of the following owners is eligible for a grant under the ALCP program?
- a. Alex is a for-profit owner of an eligible development occupied by elderly tenants and is seeking a grant for emergency repairs.
  - b. Bridgette is a nonprofit owner of an eligible development occupied by elderly tenants and is seeking a grant for capital repairs to dangerous electrical wiring.
  - c. Robert is a for-profit owner of an eligible development occupied by elderly tenants and is seeking a grant for capital repairs to repair a sewer line that frequently backs-up into the development.
  - d. Janice is a nonprofit owner of an eligible development occupied by elderly tenants and is seeking a grant to convert certain dwelling units in the project into an assisted living facility.
10. Which of the following is the most common and most often used of HUD's rent subsidy programs?
- a. Rental Assistance Payments.

- b. Rent Supplement.
  - c. Section 8 Programs.
  - d. Project Rental Assistance under the Section 202 and Section 811 capital advance programs.
11. Which of the following statements is accurate regarding the Section 8 Moderate Rehabilitation rent subsidy program?
- a. It is targeted for middle income families.
  - b. Eligible families must have incomes not exceeding 60% of the median income for the area.
  - c. Property landlords are selected by use of a lottery system.
  - d. The term of the initial Housing Assistance Payments Contract (HAP) is 15 years.
12. The term of the initial assistance contract under the Section 8 Loan Management Set Aside Program is a maximum of:
- a. 10 years.
  - b. 12 years.
  - c. 15 years.
  - d. 20 years.
13. The mark-to-market (M2M) restructuring program involves the restructuring of debt on certain multifamily properties insured by FHA that have above market rents on their Section 8 contracts. If the existing mortgage is paid in full prior to its maturity date, it is replaced with a new FHA-insured loan. A new second mortgage, if necessary, is provided directly by HUD and is referred to as the:
- a. Contingent Repayment Note (CRN).
  - b. Mortgage Restructuring Note (MRN).
  - c. Do not select this answer choice.
  - d. Do not select this answer choice.
14. Of the following statements, which one is misstated regarding the provisions/requirements of a typical M2M restructuring?
- a. Requires a capital advance from the owner to cover a portion of transaction costs and costs of rehabilitation.
  - b. Capital advances must come from surplus cash after restructuring and/or nonproject cash.
  - c. Payments are subject to monthly cash flow limitations.
  - d. An incentive performance fee is provided and is calculated at 3% of effective gross income.

15. Which of the following documents specify the duties the management agent is to perform for the project and the fees paid to the management agent?
- a. Form HUD-9839-B.
  - b. Form HUD-9839-C.
  - c. Do not select this answer choice.
  - d. Do not select this answer choice.
16. Of the following rules, which one accurately reflects the rules regarding distributions of surplus cash to property owners?
- a. If surplus cash exceeds the allowable distribution and all cumulative distributions have been paid, the excess must be deposited into a residual receipts account.
  - b. Distributions are permitted in the case of a project under a forbearance agreement, but not in the case of a project that is in default under the regulatory agreement or note.
  - c. Required cost certifications must be submitted to HUD no longer than 30 days after distributions have been made.
  - d. Section 8 New Construction and Substantial Rehabilitation projects generally are allowed to pay distributions semiannually.
17. Which of the following can be included in the calculation of surplus cash?
- a. Insurance proceeds receivable.
  - b. Cash reported in the balance sheet.
  - c. Escrow deposits.
  - d. Amounts due from related parties.
18. HUD field offices evaluate the performance of project owners and their management agents from time to time using Form HUD-9834. HUD uses Part E of Form HUD-9834 for which of the following purposes?
- a. Assessment of management's accounting procedures and cash controls and the adequacy of the project's reserves.
  - b. Assessment of management's procedures for selecting tenants and billing HUD for rent subsidy payments.
  - c. Do not select this answer choice.
  - d. Do not select this answer choice.

# Lesson 2: Compliance Audits of Nonsupervised Mortgagees, Loan Correspondents, and Lenders

## INTRODUCTION

HUD insures loans originated by HUD-approved financial institutions, such as banks and savings and loan associations, to finance the purchase of single family and multifamily housing. The lenders, referred to as “supervised” mortgagees, are subject to periodic review by the Single Family Branch. HUD also approves three other types of financial institutions for participation in HUD loan programs. Such institutions, referred to as nonsupervised mortgagees, loan correspondents, and lenders, must submit audited financial statements to HUD annually. In addition, nonsupervised mortgagees, lenders, and, in some cases, loan correspondents must have annual compliance audits conducted in accordance with the HUD audit guide.

### Scope of This Lesson

The HUD audit consists of two parts—the compliance audit and the financial statement audit. The focus of this lesson is on compliance audits of nonsupervised mortgagees, loan correspondents, and lenders. Its objective is to assist auditors in complying with the compliance provisions contained in Chapters 7 and 8 of the HUD audit guide. This lesson also includes a discussion of handbooks, mortgagee letters, and Title I letters issued by HUD that are relevant to compliance audits of nonsupervised mortgagees, loan correspondents, and lenders. This course does not provide practice aids for compliance audits of nonsupervised mortgagees, loan correspondents, and lenders, nor does it provide guidance on financial audits of such entities.

### Learning Objectives:

Completion of this lesson will enable you to:

- Define terms and compliance requirements for HUD audit programs.
- Summarize compliance requirements applicable to Title II nonsupervised mortgagees and loan correspondents and those compliance requirements that are specifically applicable to Title I nonsupervised lenders and loan correspondents.

### Nonsupervised Mortgagees versus Supervised Mortgagees

It is important to understand the difference between nonsupervised and supervised mortgagees. The distinction is important because only nonsupervised mortgagees are required to have an audit performed in accordance with the HUD audit guide.

A *nonsupervised* mortgagee is a financial institution that, as its principal activity, lends or invests funds in real estate mortgages. A nonsupervised mortgagee may submit applications for mortgage insurance and purchase, service, and sell insured mortgages. It is an institution that does not meet the requirements of a supervised mortgagee. A mortgage company is an example of a nonsupervised mortgagee.

A *supervised* mortgagee is a financial institution that is a member of the Federal Reserve System or an institution whose accounts are insured by the Federal Deposit Insurance Corporation or the National Credit Union Administration. A supervised mortgagee may originate mortgages and submit applications for mortgage insurance. A supervised mortgagee may also purchase, service, and sell insured mortgages. Banks, savings and loans, and credit unions are examples of supervised mortgagees. Because supervised mortgagees are subject to other regulatory audit requirements and are not required to have an audit performed in accordance with the HUD audit guide, they are not discussed in this course.

### Loan Correspondents

A loan correspondent is a mortgagee that, as its principal activity, originates mortgages for sale or transfer to another institution, referred to as its *sponsor*. A loan correspondent may submit applications for the insurance of

mortgages. A loan correspondent cannot purchase or service insured mortgages and cannot sell insured mortgages to any mortgagee other than its sponsor without prior HUD approval.

Examples of loan correspondents include mortgage companies that have chosen not to apply for “nonsupervised mortgagee” status and financial services companies that originate loans.

## Title II Program Participants

In the HUD literature, the term *Title II program* refers to the broad range of housing programs authorized under Title II of the National Housing Act of 1934. Title II programs provide financing to owners of single family and multifamily housing.

Nonsupervised mortgagees can participate in both the single family and multifamily loan programs. Loan correspondents primarily participate in single family loan programs. Exhibit 2-1 summarizes the differences and similarities between Title II nonsupervised mortgagees and loan correspondents.

Title II nonsupervised mortgagees and Title II loan correspondents are required to submit to HUD audited financial statements and a schedule of adjusted net worth.

Title II loan correspondents may not be required to obtain or submit internal control or compliance reports at the program level. A revision to Chapter 7 of the HUD audit guide released in April 2007 provides guidance to clarify the auditor's responsibility for reporting on compliance when the loan correspondent's sponsor agrees to assume the responsibility for assuring compliance.

### Exhibit 2-1

#### Title II Nonsupervised Mortgagees and Loan Correspondents

Activity	Nonsupervised Mortgagee	Loan Correspondent
Participate in single family loan programs	Yes	Yes
Participate in multifamily loan programs	Yes	Yes
Originate loans	Yes	Yes
Service loans	Yes	No
Purchase loans	Yes	No
Sell loans	Yes	May not sell to a mortgagee other than its sponsor without prior HUD approval

\* \* \*

## Title I Program Participants

The term *Title I program* refers to HUD lending programs that are authorized under Title I of the National Housing Act. The Title I program, which is used primarily to finance property improvements and purchases of manufactured homes and lots, is smaller than the Title II programs in terms of the number of program offerings and the number of participating institutions. The financial institutions that participate in the Title I program are referred to as nonsupervised lenders and loan correspondents. Title I nonsupervised lenders and loan correspondents are subject to the provisions of Chapter 8 of the HUD audit guide.

## FHA Approved Mortgagees

FHA loan origination services must be performed by an FHA-approved lender or FHA-approved mortgage broker (loan correspondent). To be approved for participation in the FHA mortgage insurance programs, the mortgagee



must meet specific initial and continuing FHA requirements as well as the specific requirements that apply to the type of mortgagee for which it seeks approval. Chapter 2 of HUD HB 4060.1 Rev 2 contains the details of the requirements specific to FHA approval.

## Definitions

Throughout this lesson, the following terms are used:

- *Loan Origination.* Covers all activities from the original loan application to loan settlement.
- *Loan Underwriting.* Covers all functions relating to assessing the overall acceptability of the loan for HUD insurance purposes. The underwriter reviews credit analyses, appraisal reports, and inspection reports, and makes conclusions about the borrower's ability (or inability) to repay the mortgage. HUD may serve as the underwriter but, in the case of the direct endorsement program, which generates the vast majority of single family mortgages, a mortgagee serves as underwriter.
- *Loan Settlement.* Covers activities surrounding the disbursement of the loan proceeds. Also referred to as *loan closing*.
- *Loan Servicing.* Covers all functions relating to collecting loan payments.
- *Direct Endorsement Program.* A HUD program that allows nonsupervised mortgagees and supervised mortgagees to underwrite and close loans for single family homes without prior HUD approval.
- *Sponsor.* An entity that purchases loans originated by a loan correspondent. In the case of HUD's direct endorsement program, the sponsor serves as underwriter of the loan originated by its loan correspondent. A sponsor can be either a nonsupervised mortgagee or a supervised mortgagee, such as a bank or savings and loan.
- *Single Family Home.* Housing that consists of four dwelling units or less.
- *Multifamily Housing.* Housing that consists of more than four dwelling units.

## Audit Planning Consideration

The auditor is required to express an opinion on compliance with requirements applicable to major HUD programs separate from a report on nonmajor HUD programs. According to the HUD audit guide, a mortgagee or loan correspondent that originates and/or services an aggregate of FHA-insured loans exceeding \$300,000 during the audit period is considered a major program.

The HUD audit guide requires every participating nonsupervised mortgagee, loan correspondent, and lender to submit the required reports regardless of the number of loans originated or serviced during the year. Thus, the auditor should plan to perform the procedures necessary to satisfy the compliance requirements and issue the required reports.

## Reporting Considerations

**General Reporting Considerations.** The auditor is required to issue a report on the client's compliance with HUD laws and regulations. The HUD audit guide, at Paragraph 7-4A, states that all material instances of noncompliance with any HUD requirements identified by the auditor must be reported as findings in the report on compliance. Paragraph 7-7 of the HUD audit guide further explains that the matters required to be reported as audit findings include noncompliance matters such as adjusted net worth and/or liquidity deficiencies, deficiencies in internal control, instances of fraud or illegal acts, or contract violations. Immaterial instances of noncompliance, deficiencies in internal control, instances of fraud or illegal acts, or contract violations may be reported separately to management if not reported as audit findings. The separate reporting must be a written communication and may be in the form of a management letter. All instances of noncompliance, deficiencies in internal control, instances of fraud or illegal acts, or contract violations should be reported, even when corrective action has been taken by the

auditee. Noncompliance matters that have been corrected should be reported as resolved findings in the auditor's report on compliance or in the other written communication to management, depending on the auditor's judgment of materiality. The compliance report is included in the financial report that the client must submit to HUD each year. Every nonsupervised mortgagee, loan correspondent, and lender must submit the required reports regardless of the number of loans originated or serviced during the year.

**Electronic Submission.** Mortgagee Letter 03-03, *Mandatory Electronic Submission of Financial Statement Package for Annual Mortgagee Recertification*, extends the Uniform Financial Reporting Standards to all Title I and Title II nonsupervised mortgagees, lenders, and loan correspondents. As a result, these entities submit their financial and compliance data electronically to HUD using the Internet-based Lender Assessment Subsystem (LASS). LASS is similar to the FASSUB system, which is used by multifamily project owners.

The submission process consists of the following broad phases:

- Registration in the system by the appropriate parties (lender, auditor, etc.)
- Entry of financial and compliance data into the LASS template.
- Auditor review of template data and attestation.
- Lender submission of template data to HUD via LASS.

The LASS template must be submitted to HUD within 90 days of the client's fiscal year end. The templates contain detailed financial information that must be covered by a SAS No. 29 opinion. Therefore, the auditor should be aware of the required level of detail before performing the audit to prevent any problems with reporting at the end of the engagement. As with FASSUB, the auditor should issue paper copies of all auditors' reports and corresponding financial information that is included in the LASS submission.

While similar to using FASSUB for multifamily project owners, LASS has several key differences. In LASS the auditor cannot also serve as the coordinator, and the auditor submitter must be a different user from the independent public accountant who attests to the financial information. In addition, LASS administration is performed by the Home Ownership Center rather than REAC.

The LASS templates, detailed instructions, explanatory guidance, contact information, and frequently asked questions are available at [www.hud.gov/offices/hsg/sfh/lass/prodllass.cfm](http://www.hud.gov/offices/hsg/sfh/lass/prodllass.cfm). When a Title II nonsupervised mortgagee is also a Ginnie Mae issuer, a paper copy of the financial report must be sent to Ginnie Mae in accordance with Chapter 6 of the HUD audit guide.

**A Word of Caution for Title I Clients.** HUD HB 4700.2, Paragraph 7-4, discusses a Title I lender's responsibility to submit financial statements to HUD as part of the lender recertification process. That paragraph states that the auditor's opinion accompanying the financial statements "...must be unqualified."

The HUD staff enforces this requirement strictly when determining a Title I lender's fitness for recertification. In fact, several Title I lenders have had their recertification applications rejected by HUD because the financial statements were accompanied by auditor's reports that were qualified for GAAP departures. It is recommended that auditors advise their Title I clients about HUD's position on qualified opinions. Normally, once the consequences of a qualified opinion are explained to the client, the client can be persuaded to adjust the financial statements.

## Regulatory Developments

HUD has revised certain regulations impacting the single and multifamily mortgage programs. Some of those revisions include issuing an Interim Rule for the Home Equity Conversion Mortgage (HECM) program. During 2004, HUD issued an interim rule amending parts of 24 CFR Part 206. The amendments are explained below:

- Part 206.31 (allowable charges and fees) allows the mortgagee to charge to compensate for expenses incurred in originating and closing the mortgage loan. According to Part 206.31, "the mortgagor is not permitted to pay any additional origination fee of any kind to a mortgage broker or loan correspondent. A

mortgage broker's fee can be included as part of the origination fee if the mortgage broker is engaged independently by the homeowner and if there is no financial interest between the mortgage broker and the mortgagee.”

- Part 206.53 defines *total cost of refinancing*, modifies the initial MIP limit, introduces anti-churning disclosure, and waives the counseling requirement (under specific conditions).

Other actions by HUD include the following:

- The issuance of a final rule revising parts of 24 CFR Part 203.49 (Adjustable Rate Mortgages program). The changes specifically address frequency of interest rate changes and preloan disclosure in accordance with the Truth in Lending Act.
- The publication in the May 2, 2005 Federal Register of actions taken by the Mortgagee Review Board. This notice advises the public of the cause and description of the administrative actions taken by HUD against certain HUD-approved mortgagees.
- During 2006 and 2007 the FHA issued several Mortgagee Letters addressing the HECM program. ML 06-20 permits subordination of liens and judgments to HECM loans; ML 06-23 eliminates photo identification evidence for the borrower; MH 06-25 encourages (but does not require) housing counseling for persons who are *not* borrowers, but have an interest in the real estate; and ML 07-08 makes the face to face interview optional.
- ML 06-30 discusses implementation guidance for certain new requirements in HUD HB. 4060.1 REV-2, *FHA Title II Mortgagee Approval Handbook*, issued in August 2006.
- ML 07-03 “Revision of Preservation and Protection Requirements and Cost Reimbursements,” replaces previous guidance regarding allowable preservation costs and inspection requirements. Given the current high rate of defaults in single-family housing programs, all servicing mortgagees should be familiar with the new cost ceilings as well as inspection requirements.

Additionally, in late 2004, the Board of Governors of the Federal Reserve System published revised formats for public disclosure of lending data (see the Federal Register issue for Monday, December 20, 2004, pages 76190 through 76296).

## FHA/HUD Violations

The Mortgagee Review Board (MRB) oversees the performance of FHA lenders to ensure compliance with FHA/ HUD requirements. The MRB takes action against lenders for violating FHA/ HUD requirements. Any FHA approved lender within the Title I and Title II program could go before the MRB. This includes lenders involved in Single Family and Multifamily insurance programs. The Board has strengthened its commitment to ensuring that mortgagees conduct timely property inspections of FHA-insured multifamily projects. Multifamily mortgagees must make sure that physical inspections of their properties are done periodically and in a timely manner. Project owners also must comply with inspection requirements that mandate a property must be physically sound.

When mortgagees do not comply, they receive a “Notice of Violation (NOV).” The MRB is authorized to impose a range of administrative sanctions from a letter of reprimand to withdrawal of a mortgagee’s FHA approval. The MRB may also impose civil money penalties.

In April, 2009, in accordance with Section 202(c) of the National Housing Act, HUD published a notice in the Federal Register advising of the cause and description of administrative actions taken by the MRV against HUD-approved mortgagees from November 2007 to March 12, 2009. These violations resulted in actions that ranged from

penalties to withdrawal of HUD/FHA approval. Following is a list of some of the types of violations that were reported:

- Failure to implement a Quality Control Plan.
- Permitted non-approved broker to originate a Home Equity Conversion Mortgage loan.
- Failure to verify borrower's income from child support
- Failure to insure borrowers met minimum credit requirements or credit was not properly verified
- Used false and misleading advertising by inappropriately displaying the official HUD seal.

In addition to the above, numerous violations of HUD/FHA requirements for annual recertification of HUD/FHA approval were noted. Auditors should be aware of the kinds of violations that could result in client being subject to significant fines or restitution payments.

**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. A *nonsupervised* mortgagee may **not** perform which of the following actions regarding mortgages?
- a. Originate mortgages.
  - b. Submit applications for mortgage insurance.
  - c. Purchase insured mortgages.
  - d. Service insured mortgages.
22. Which of the following statements regarding Title I and Title II housing programs authorized under the National Housing Act of 1934 is accurate?
- a. Title II nonsupervised mortgagees and Title II loan correspondents are not required to submit to HUD audited financial statements.
  - b. Title II correspondents are always required to obtain and submit internal control and compliance reports at the program level.
  - c. Title I programs are smaller than Title II programs in terms of the number of program offerings.
  - d. Title I nonsupervised lenders and loan correspondents are not subject to the provisions of Chapter 8 of the HUD audit guide.
23. *Loan \_\_\_\_\_* covers activities surrounding the disbursement of the loan proceeds.
- a. *Origination.*
  - b. *Underwriting.*
  - c. *Settlement.*
  - d. *Servicing.*
24. Which of the following is common to both the LASS and FASSUB systems?
- a. Auditor should issue paper copies of all auditors' reports and corresponding financial information.
  - b. The auditor can also serve as the coordinator.
  - c. The auditor submitter can be the same user as the independent public accountant who attests to the financial information.
  - d. Administration of both systems is performed by the Home Ownership Center.

**SELF-STUDY ANSWERS**

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

21. A *nonsupervised* mortgagee may **not** perform which of the following actions regarding mortgages? **(Page 131)**

- a. **Originate mortgages. [This answer is correct. A *supervised* mortgagee may originate mortgages, but a *nonsupervised* mortgagee may not.]**
- b. Submit applications for mortgage insurance. [This answer is incorrect. Both *supervised* and *nonsupervised* mortgagees may submit applications for mortgage insurance.]
- c. Purchase insured mortgages. [This answer is incorrect. A *nonsupervised* mortgagee *may* purchase insured mortgages.]
- d. Service insured mortgages. [This answer is incorrect. A *nonsupervised* mortgagee *may* service (and sell) insured mortgages.]

22. Which of the following statements regarding Title I and Title II housing programs authorized under the National Housing Act of 1934 is accurate? **(Page 132)**

- a. Title II nonsupervised mortgagees and Title II loan correspondents are not required to submit to HUD audited financial statements. [This answer is incorrect. Title II nonsupervised mortgagees and Title II loan correspondents *are* required to submit to HUD audited financial statements.]
- b. Title II correspondents are always required to obtain and submit internal control and compliance reports at the program level. [This answer is incorrect. Title II correspondents *may not* be required to obtain or submit internal control or compliance reports at the program level.]
- c. **Title I programs are smaller than Title II programs in terms of the number of program offerings. [This answer is correct. Title I programs are smaller than Title II programs in terms of both the number of program offerings and the number of participating institutions.]**
- d. Title I nonsupervised lenders and loan correspondents are not subject to the provisions of Chapter 8 of the HUD audit guide. [This answer is incorrect. Title I nonsupervised lenders and loan correspondents *are* subject to the provisions of Chapter 8 of the HUD audit guide.]

23. *Loan* \_\_\_\_\_ covers activities surrounding the disbursement of the loan proceeds. **(Page 133)**

- a. *Origination*. [This answer is incorrect. *Loan Origination* covers all activities from the original loan application to loan settlement.]
- b. *Underwriting*. [This answer is incorrect. *Loan Underwriting* covers all functions relating to assessing the overall acceptability of the loan for HUD insurance purposes.]
- c. ***Settlement*. [This answer is correct. *Loan Settlement* covers activities surrounding the disbursement of the loan proceeds, and is also referred to as *loan closing*.]**
- d. *Servicing*. [This answer is incorrect. *Loan Servicing* covers all functions relating to collecting loan payments.]

24. Which of the following is common to both the LASS and FASSUB systems? **(Page 134)**

- a. **Auditor should issue paper copies of all auditors' reports and corresponding financial information.** [This answer is correct. As is the case with the FASSUB system, the auditor should issue paper copies of all auditors' reports and corresponding financial information that is included in the LASS submission.]
- b. The auditor can also serve as the coordinator. [This answer is incorrect. With LASS submissions, the auditor *cannot* also serve as the coordinator.]
- c. The auditor submitter can be the same user as the independent public accountant who attests to the financial information. [This answer is incorrect. The auditor submitter must be a different user from the independent public account who attests to the financial information with LASS submissions.]
- d. Administration of both systems is performed by the Home Ownership Center. [This answer is incorrect. LASS administration is performed by the Home Ownership Center. FASSUB administration is performed by REAC.]



## IDENTIFICATION OF COMPLIANCE REQUIREMENTS

The purpose of this section is to assist auditors in identifying compliance requirements applicable to nonsupervised mortgagees, loan correspondents, and lenders. Sources of information include the HUD audit guide, statutes, and regulations published in the *Code of Federal Regulations*, HUD handbooks, Mortgagee Letters, and Title I Letters.

### HUD Audit Guide

Chapter 7 of the HUD audit guide applies to mortgagees and loan correspondents that participate in Title II programs. Chapter 8 of the HUD audit guide applies to nonsupervised lenders and loan correspondents that participate in Title I programs.

Although the HUD audit guide identifies compliance requirements, it is a summary. Auditors will always need to refer to other HUD handbooks, mortgagee letters, Title I letters, and, in most cases, to the implementing regulations cited in the HUD audit guide.

On April 27, 2007, HUD released a revision to Chapter 7 of the HUD audit guide, which was effective for audits for entities with fiscal years ending on or after June 30, 2007. The significant changes in the new chapter include the following:

- Reporting requirements for Title II loan correspondents are clarified (Paragraph 7-4A.)
- Electronic reporting requirements are added (Paragraphs 7-4B through 7-4C.)
- Compliance requirements and suggested audit procedures are added, clarified, or revised (Section 7-5.)
- A section on reporting audit findings is added (Section 7-7.)

Each significant revision in Chapter 7 of the HUD audit guide has been denoted by HUD with an asterisk at the beginning and at the end of the new or revised material.

**Title II Loan Correspondents.** The revision to Chapter 7 of the HUD audit guide released in April 2007 and the revision of HUD Handbook 4060.1, REV-2, *FHA Title II Mortgagee Approval Handbook*, released in August 2006, provide new guidance whereby Title II loan correspondents *may be* exempt from the requirement to obtain and submit internal control or compliance reports at the program level. It is believed the new guidance *may narrow* the exemption from reporting on internal control or compliance at the program level that existed previously. To avoid problems that could occur during the transition to the new guidance, or due to interpretation of the guidance, it is recommended that auditors discuss the audit and reporting requirements related to their Title II loan correspondent audit clients with the appropriate HUD official early in the audit planning process.

Paragraph 7-4 of the HUD audit guide reflects the changes promulgated in HUD HB 4060.1 REV-2, Paragraph 4-4A. Given the substantial nature of the revision, the relevant section of paragraph 7-4 is reproduced in its entirety as follows:

For Title II loan correspondents, the requirement for the auditor to review and report on the mortgagee's compliance has been modified under the condition that the sponsor agrees to assume the responsibility of assuring compliance for each loan correspondent under its sponsorship. In those instances in which the sponsor agrees to assume the responsibility of assuring compliance of loan correspondents under its sponsorship, the sponsor must communicate annually in writing to the individual loan correspondents its intent to assume responsibility for their compliance, indicate the areas of compliance that it will be assuming, issue annually a written report summarizing the results of its compliance testing, and accumulate and retain the supporting information that served as the basis for the written annual compliance report issued to the loan correspondent. In accordance with the Yellow Book, it is incumbent upon the auditor to test and report on those areas of compliance not assumed by the sponsor. In addition, the auditor must determine where applicable that the sponsors are testing and reporting the

results of their compliance reviews. Accordingly, when meeting the requirements of Yellow Book, the auditor should issue a report on compliance and on internal control over financial reporting based on an audit of financial statements performed in accordance with government auditing standards. The report may vary depending on whether there are reportable instances of noncompliance or material weaknesses. However, if the nonsupervised loan correspondent is also approved under the Title I program, separate reports on internal control and compliance will have to be issued for that program.

If the circumstances described above apply, internal control and compliance should be reported on at the financial statement level in accordance with *Government Auditing Standards*. In that case, it is recommended that the Yellow Book reporting example be issued, in addition to the report on the financial statements and the schedule of adjusted net worth. In accordance with this new guidance a compliance requirement for the sponsor's responsibility over Title II loan correspondents was added in the 2007 revision to Chapter 7 of the HUD audit guide.

## Statutes and Implementing Regulations

The loan programs discussed in this lesson derive their authority from Title I and Title II of the National Housing Act. Appropriations acts enacted separately actually fund the various programs.

HUD issues regulations to implement each program (commonly referred to as *implementing regulations*) and publishes them in the *Code of Federal Regulations* (CFR). The nature of the topics addressed in implementing regulations varies from program to program but generally includes requirements that are unique to the program, e.g., types of lenders and borrowers eligible to participate, a description of the lender's loan origination and servicing obligations, and ongoing reporting requirements.

Regulations for the single family loan programs are found primarily in 24 CFR 201-3, and regulations for the multifamily loan programs are found primarily in 24 CFR 207. The auditor will sometimes need to refer to program-specific requirements found throughout 24 CFR, parts 200–299.

## HUD Handbooks

HUD has issued numerous handbooks that describe the requirements to be followed by program participants. The handbooks, which are discussed in the following paragraphs, can be ordered by calling HUD at (800) 767-7468 or by accessing HUD information on the Internet.

**Multifamily Programs.** The following HUD handbooks are applicable to multifamily programs and are of greatest compliance significance to the auditor:

- HB 4060.1, REV-2, *FHA Title II Mortgagee Approval Handbook*, issued 8/14/2006. This handbook discusses procedures for obtaining approval to participate as a mortgagee or loan correspondent. The handbook also provides detailed information on the "quality control plan" that program participants must establish and maintain.
- HB 4470.1, REV-2, *Mortgage Credit Analysis for Project Mortgage Insurance*, issued 10/6/94 (through Change 2, dated 6/10/04). This handbook discusses credit analysis activities pertinent to multifamily housing programs.
- HB 4350.1, REV-1, *Multifamily Asset Management and Project Servicing*, issued 9/22/92 (through Change 9, dated 1/23/96). This handbook discusses multifamily loan servicing activities.
- HB 4350.4, *Insured Multifamily Mortgage Servicing and Field Office Remote Monitoring*, issued 2/92 (through Change 7, dated 6/26/96). This handbook discusses servicing activities applicable to multifamily HUD-insured loans.

- HB 4566.2, *Management, Servicing, and Disposition Requirements for Projects With 223(f) Coinsured Loans*, issued 5/8/84 (through Change 1, dated 8/95). This handbook discusses servicing co-insured loans made for purchasing or refinancing existing multifamily projects.

**Single Family Programs.** The following HUD handbooks apply to single family programs and are of greatest compliance significance to the auditor:

- HB 4060.1, REV-2, *FHA Title II Mortgagee Approval Handbook*, issued 8/14/2006. This handbook discusses procedures for obtaining approval to participate as a mortgagee or loan correspondent. The handbook also provides detailed information on the "quality control plan" that program participants must establish and maintain. It also incorporates HUD's FHA Title II mortgagee approval and renewal requirements in addition to all Mortgagee Letters issued from September 1993 through October 2005 pertaining to the FHA mortgagee approval requirements.
- HB 4000.2, REV-3, *Mortgagee's Handbook, Application through Insurance*, issued 5/20/04. This handbook discusses loan underwriting, credit analysis, and loan settlement activities.
- HB 4000.4, REV-1, *Single Family Direct Endorsement Program*, issued 9/2/88 (through Change 2, dated 7/13/94). This handbook discusses procedures for obtaining approval to participate in the single family direct endorsement program.
- HB 4155.1, REV-5, *Mortgage Credit Analysis for Mortgage Insurance on One- to Four-Family Properties*, issued 10/20/03. The handbook discusses mortgage credit analysis and procedures for documenting loan acceptance.
- HB 4205.1, *Single Family Coinsurance Program Handbook*, issued 8/10/76. This handbook discusses HUD's single family coinsurance program.
- HB 4235.1, REV-1, *Home Equity Conversion Mortgages*, issued 11/18/94. This handbook provides updated instructions to approved mortgagees and to HUD Field Office personnel regarding the processing and servicing of a Home Equity Conversion Mortgage (HECM).
- HB 4330.1, REV-5, *Administration of Insured Home Mortgages*, issued 9/29/94. This handbook discusses procedures for servicing single family loans.
- HB 4330.4, REV-1, *FHA Single Family Insurance Claims*, issued 9/23/94 (through Change 1, dated 4/28/95). This handbook discusses procedures for submitting claims for mortgage insurance benefits.

**Title I Programs.** The following HUD handbooks apply to Title I programs and are of greatest compliance significance to the auditor:

- HB 1060.2, REV-6, *Title I Property Improvement and Manufactured Home Loan Regulations*, issued 6/3/96. This handbook discusses the regulations (at 24 CFR 201-2) governing the Title I program.
- HB 4700.2, REV-1, *Title I Lender Approval Handbook*, issued 9/5/95. This handbook covers requirements that lending institutions must meet to participate in HUD's Title I Property Improvement and Manufactured Home programs.

## Mortgagee Letters

HUD issues mortgagee letters to address topics of current interest or to provide guidance on a specific program. They are intended to provide interim guidance until such time as the affected handbooks can be updated by HUD. Mortgagee letters can be ordered by calling HUD at (800) 767-7468 or by accessing HUD's online information and resources repository at <http://www.hudclips.org>. Mortgagee letters that should be of interest to auditors of Title II nonsupervised mortgagees and loan correspondents include the following:

- Mortgagee Letter 93-14, *Quality Control for Origination and Servicing*. This mortgagee letter addresses questions concerning the "quality control plan" that Title II nonsupervised mortgagees/loan correspondents must establish and maintain.

- Mortgagee Letter 95-6, *Annual Lender Recertification Requirements*. This mortgagee letter discusses various issues concerning the HUD requirement that nonsupervised mortgagees/loan correspondents obtain recertification annually. It discusses the net worth requirements applicable to nonsupervised mortgagees and loan correspondents.
- Mortgagee Letter 96-12, *Changes in Mortgagee Requirements*. This mortgagee letter streamlines the requirements for mortgagees participating in the FHA mortgage insurance programs. It discusses the submission of financial statements to HUD as part of the lender recertification process. (All but item #2 in this letter was superseded with the issuance of HUD Handbook 4060.1 Rev-2 in August 2006.)
- Mortgagee Letter 97-15, *Home Equity Conversion Mortgage (HECM) Insurance Program*. This mortgagee letter addresses changes to the HECM program, including principal limit definition, monthly payment calculations, life estate provisions, prepayment, and documentation requirements for direct endorsement lenders.
- Mortgagee Letter 97-24, *Single Family Quality Control—FHA Quality Assurance Agreement*. This mortgagee letter discusses the national “Quality Assurance Agreement” between the Federal Housing Administration and the Mortgage Bankers Association of America. This agreement encourages timely, voluntary reporting of program violations and unacceptable activities detected by lenders. In return, HUD will provide meaningful loss mitigation incentives to the lender.
- Mortgagee Letter 97-26, *Single Family Loan Production—Credit Policy Issues*. This mortgagee letter alerts mortgagees of various borrower credit and capacity and property collateral issues with single family loan underwriting.
- Mortgagee Letter 99-2, *Implementation of the Final Rule-HECM Consumer Protection Measures*. This mortgagee letter requires the mortgagee to provide an estimate of all costs, including estate planning and financial advice, that are related to the mortgage but are not required to obtain a HECM loan. The mortgagee must also inform the borrower that such services are ineligible for payment from proceeds of the HECM.
- Mortgagee Letter 98-26, *Single Family Default and Foreclosure Servicing Policy and Procedural Changes Including HUD Schedule of Allowable Attorney Fees* (ML 98-26) and Mortgagee Letter 99-8, *Clarification of Mortgagee Letter 98-26* (ML 99-8). With ML 98-26, HUD published a Schedule of Allowable Attorney Fees. Prior to the issuance of ML 98-26, HUD allowed mortgagees to use the FNMA Schedule of Standard Attorney's Fees. ML 99-8 establishes the cutoff date for which the FNMA schedule was replaced with HUD's schedule.
- Mortgagee Letter 99-12, *Electronic Submission of Required Data for Filing Notices of Default on Multifamily Mortgages*. Effective March 1, 1999 for some mortgagees (phased in based on number of insured mortgage loans), mortgagees must submit electronically information regarding mortgage delinquencies, defaults, reinstatements, elections to assign, and withdrawals of assignment elections.
- Mortgagee Letter 99-13, *Single Family Loan Production—Termination of the CHUMS Lender Access System (CLAS)*. Effective April 1, 1999, lenders must use the FHA Connection. HUD will no longer accept data from the CLAS system.
- Mortgagee Letter 99-15, *Mortgagee Approval for Single Family Programs—Clarification of Procedures for Terminating Origination Approval Agreements and Placement in Credit Watch Status* (ML 99-15). This mortgagee letter supersedes Mortgagee Letter 95-37. ML 99-15 advises mortgagees with high rates of early defaults and claims that HUD/FHA will be using its regulatory authority to terminate such mortgagees' authorization to originate single family loans or place lenders on “credit watch status” (a warning).
- Mortgagee Letter 00-05, *Loss Mitigation Program—Comprehensive Clarification of Policy and Notice of Procedural Changes*. This mortgagee letter provides clarifications of policy and procedural changes in FHA's Loss Mitigation Program and consolidates the existing program guidance. It provides strategies that may be used by mortgagees with respect to defaulted single-family loans and indicates that HUD provides financial incentives to mortgagees utilizing the strategies.

- Mortgagee Letter 00-10, *Revisions to the Home Equity Conversion Mortgages (HECMs) Program*. This mortgagee letter describes several changes to the HECMs program, including (a) a cap on the origination fee at the greater of \$2,000 or 2% of the maximum claim amount, (b) a mandate for borrower counseling, (c) recognition of FNMA's counseling program, and (d) the elimination (consistent with Mortgagee Letter 98-15) of the face-to-face interview requirement.
- Mortgagee Letter 01-26, *Disclosure of Yield Spread Premiums Under RESPA*. This mortgagee letter describes recommended forms of disclosure by lenders to applicants and borrowers with respect to the yield spread premium.
- Mortgagee Letter 04-10, *Adjustable Rate Mortgages*. This mortgagee letter discusses HUD's policy regarding expanded (hybrid) ARMs.
- Mortgagee Letter 04-16, *Interactive Website for Preservation and Protection Cost Allowables*. This mortgagee letter is applicable for loan servicers.
- Mortgagee Letter 04-44, *TOTAL Mortgage Scorecard Update*. This mortgagee letter identifies numerous errors that lenders are making when using TOTAL. It also provides guidance regarding the use of a borrower's retirement account and qualifying gifts when scoring an application.
- Mortgagee Letter 05-05, *Property Flipping Prohibition Technical Amendments*. This mortgagee letter references an interim rule published December 23, 2004 in the Federal Register in which HUD amended regulations at 24 CFR 203.37a that prohibit property flipping in the single family mortgage insurance programs and provide certain exceptions to the time restrictions on sales.
- Mortgagee Letter 05-06, *Lender Accountability for Appraisals*. The purpose of this mortgagee letter is to remind lenders of their responsibilities for the quality of appraisals for properties that will be security for FHA-insured mortgages (as provided for in 24 CFR 203.5) and to further note that, in accordance with 24 CFR 25.9, documentation relating to an appraisal that does not satisfy FHA requirements is grounds for an administrative sanction by the Mortgagee Review Board.
- Mortgagee Letter 05-14, *Five-Year Hybrid Adjustable Rate Mortgages (ARMs)*. This mortgagee letter modifies guidance in Mortgagee Letter 2004-10 by providing new a cap structure option.
- Mortgagee Letter 05-17, *Transfer of Home Mortgage Disclosure Act (HMDA) Data Collection to the Federal Reserve Board*. This mortgagee letter states that HMDA data collection will henceforth be submitted to the Board of Governors of the Federal Reserve, not HUD.
- Mortgagee Letter 05-36, *Lender Insurance Program*. This mortgagee letter announces that effective January 1, 2006 FHA offers a Lender Insurance Program, which enables high-performing FHA-approved Direct Endorsement mortgagees to endorse FHA mortgage loans without a pre-endorsement review conducted by FHA.
- Mortgagee Letter 05-43, *Revised Refinance Transactions*. This mortgagee letter addresses changes to cash-out refinancing transactions, revised latitude in shortening the term of mortgages, and revised requirements for converting an FHA-Hybrid to a fixed-rate mortgage.
- Mortgagee Letter 05-44, *Home Equity Conversion Mortgage (HECM) Program—Expanded National HECM Counseling Network*. This mortgagee letter announces eligibility of HECM counselors from the National Foundation for Credit Counseling and Money Management International to serve as HECM counselors.
- Mortgagee Letter 05-50, *Enhancements to "Streamlined (k)" Limited Repair Program*. This mortgagee letter replaces ML 05-19, and addresses additional eligible work items, increased maximum mortgage amount, and eliminates the minimum repair cost threshold.
- Mortgagee Letter 06-04, *Revised Borrowers Closing Costs Guidelines*. This mortgagee letter rescinds previous FHA instructions dictating allowable closing costs and other fees, and replaces these instructions with "customary and reasonable" (except for prohibition on a tax service fee and caps on origination fees).



- Mortgagee Letter 06-08, *Announcement of FHA Resource Center*. This mortgagee letter announces that effective May 1, 2006 Electronic Consulting Services of Fairfax, VA created the FHA Resource Center; see [www.hud.gov/offices/hsg/sfh/fharesourcectr.cfm](http://www.hud.gov/offices/hsg/sfh/fharesourcectr.cfm). The Resource Center will handle inquiries about FHA mortgage insurance programs and requirements; the National Servicing Center will address servicing requirements.
- Mortgagee Letter 06-13, *Charitable Organizations Making Downpayment Gifts*. This mortgagee letter advises mortgagees regarding their determination as to whether a gift from a charitable organization can be used for the down payment when the charitable organization loses or gives up its federal tax-exempt status.
- Mortgagee Letter 2008-06, *Temporary Loan Limit Increases for FHA*. This mortgagee letter provides information on FHA single family mortgage limits resulting from the enactment of the Economic Stimulus Act of 2008.
- Mortgagee Letter 2008-16, *Risk-Based Premiums for FHA Mortgage Insurance*. This mortgagee letter announces that FHA will implement risk-based premiums on one- to four-unit single family mortgages, effective with new FHA case number assignments on or after July 14, 2008. The mortgagee letter contains a premium matrix that is replacing the premium matrix in Mortgagee Letter 00-38.
- Mortgagee Letter 2008-17, *Non FHA-approved Mortgage Brokers—Forward Mortgages*. This mortgagee letter reminds lenders that FHA loan original services must be performed by an FHA-approved lender or FHA-approved loan correspondent.
- Mortgagee Letter 2008-19, *Streamlined Processing of Multifamily Mortgage Insurance Applications Involving Low Income Housing Tax Credits*. This mortgagee letter announces that HUD has made four program changes to increase processing discretion to Hubs and Program centers, reduce up-front and overall transaction costs, and to improve coordination and cooperation between HUD, mortgagees and tax credit allocation agencies. Programs to which the letter applies include Section 221(d)(4), Section 220, and Section 231.
- Mortgagee Letter 2008-29, *HOPE for Homeowners Origination Guidance*. This letter announces the HOPE for Homeowners (H4H) Program which make certain borrowers facing difficulty in paying their mortgage eligible to refinance into affordable FHA-insured mortgages. The H4H Program is effective for endorsement on or after October 1, 2008 through September 30, 2011.
- Mortgagee Letter 2008-33, *Home Equity Conversion Mortgage (HECM) for Purchase Program*. This letter mortgagee letter announces the Home Equity Conversion Mortgage for Purchase Program which allows HECM borrowers to purchase a single-family residence using HECM proceeds.
- Mortgagee Letter 9009-1, *Annual Renewal of FHA Approval*. This letter announces a revised policy regarding Departmental action when mortgagees or lenders fail to meet annual renewal of FHA approval requirements. The letter states that any failure to comply with the annual renewal requirements may be referred to the Mortgagee Review Board for its consideration. A mortgagee will no longer be permitted to rectify the violation and pay a fine.
- Mortgagee Letter 2009-03, *Hope for Homeowners Origination and Servicing Guidance Supplement*". This letter describes the procedures for originating a new FHA-insured mortgage under the HOPE for Homeowners Program. The information, directions, and guidance provided in this letter reflect statutory requirements as well as the standards, policies and regulations adopted by the Board for the H4H Program.
- Mortgagee Letter 2009-15, *Using First-Time Homebuyer Tax Credits*. This letter announces an HFA-approved tax credit of up to \$8,000 to qualified homebuyers. The letter provides basic information on how the tax credit works and provides guidance on how FHA-approved mortgagees and FHA-approved nonprofit organizations, and Federal, state, and local government agencies can assess eligible homeowners. Under certain conditions, FHA-approved mortgagees and FHA-approved nonprofit organizations as well as Federal, state, and local governmental agencies and instrumentalities thereof may purchase the tax credit anticipated by the homebuyer.

## Title I Letters

Title I letters provide guidance on the Title I Property Improvement and Manufactured Home programs. They are intended to serve as interim guidance until such time as the affected handbooks can be updated by HUD. Title I letters can be ordered by calling HUD at (800) 767-7468 or by accessing HUD's online information and resources repository at <http://www.hudclips.org>.

On March 15, 2000, HUD issued TI-470, *Clarifications to the Title I Property Improvement Program*. This letter reiterates certain existing policies related to origination, loan servicing, and claims issues. The letter also advises program participants of a proposed rule that would substantially modify existing program requirements. The letter describes the first of these modifications related to the lenders' quality control plan. Other modifications, including an increase in the minimum net worth requirement, are also being proposed.

On December 7, 2001, HUD issued TI-473, *Publication of Final Rule on November 7, 2001 Regarding: Strengthening the Title I Property Improvement and Manufactured Home Loan Insurance Programs and Title I Lender/Title II Mortgagee Approval Requirements*. The letter addresses increases in Title I insurance charges, required security for property improvement loans in excess of \$7,500, procedural changes to the property improvement dealer program, and increases in net worth requirement for Title I lenders and dealers. Effective May 7, 2002, Title I property improvement dealers must have and maintain a net worth of not less than \$32,000; Title I manufactured home dealers must maintain a net worth of not less than \$63,000.

On April 14, 2009, HUD issued TI-481, *Changes to the Title I Manufactured Home Loan Program*. The letter announces changes to the Title 1 Manufactured Home Loan Program that resulted from the Housing and Economic Recovery Act of 2008. Key revisions under the act include the following:

- Increases loan limits and addresses a method of indexing for future adjustments.
- Changes insurance for manufactured home loans from portfolio insurance to individual loan insurance, and making that incontestable by the lender.
- Changes to the method of calculating premiums.
- Establishes underwriting criteria for loans and advances of credit on Title I manufactured home loan products.
- Establishes leasehold requirements for manufactured homes.

These changes coupled with the first time homebuyer tax credit (see paragraph 901.16) have the potential to significantly increase FHA activity. Auditors should be familiar with the new requirements and the impact caused by an increase in new FHA-insured loan transactions.

The FHA is in the process of developing a handbook that will provide comprehensive guidance for Title I manufactured home loan products. The FHA expects to issue the handbook in the near future.

## HUD AUDIT GUIDE'S COMPLIANCE REQUIREMENTS AND SUGGESTED PROCEDURES

The HUD audit guide, Chapters 7 and 8, identifies specific compliance requirements followed by suggested compliance audit procedures for testing the entity's compliance with those requirements. Paragraph 1-1 of the HUD audit guide observes:

Suggested audit procedures contained herein [in this guide] may not cover all circumstances or conditions encountered in a particular audit. The auditor should use professional judgement to tailor the procedures so that the audit objectives may be achieved.

The 2007 revision to Chapter 7 of the HUD audit guide includes provisions whereby a sponsor may agree to assume the responsibility of assuring that a Title II loan correspondent under its sponsorship is in compliance with HUD requirements. If the sponsor is responsible for testing a loan correspondent's compliance, the auditor would



perform the suggested audit procedures to test the *sponsor's* compliance with the applicable compliance requirement. Those requirements are included in the "Sponsor Responsibility Over Title II Loan Correspondents" compliance requirement described below. If the sponsor has not assumed responsibility for testing compliance, this compliance requirement is not applicable. See the discussion above about how a sponsor's responsibility over its loan correspondent should be considered in the auditor's reports on internal control and on compliance.

## **TITLE II NONSUPERVISED MORTGAGEES AND LOAN CORRESPONDENTS SPECIFIC REQUIREMENTS**

Chapter 7 of the HUD audit guide identifies 11 specific compliance requirements and suggested audit procedures applicable to nonsupervised mortgagees and loan correspondents or their sponsors that participate in Title II programs:

- a. Quality Control Plan.
- b. Sponsor Responsibility Over Title II Loan Correspondents.
- c. Branch Office Operations.
- d. Loan Origination.
- e. Loan Settlement.
- f. Loan Servicing.
- g. Escrow Accounts.
- h. Section 235 Assistance Payments.
- i. Federal Financial and Activity Reports.
- j. Kickbacks.
- k. Mortgagee Approval Requirements.

The following paragraphs discuss the compliance requirements and the HUD audit guide's procedures for testing compliance with those requirements.

### **Quality Control Plan**

HUD requires that nonsupervised mortgagees and loan correspondents maintain a quality control plan. The quality control plan is a written document containing policies and procedures that are designed to ensure that the client's loan origination and servicing activities are being performed in accordance with HUD laws and regulations. HUD requires that quality control be a prescribed and routine function of each mortgagee's origination and servicing operations. The quality control plan must be in writing and the quality control function must be independent from the origination and servicing functions. Components of the quality control plan are described in HUD HB 4060.1 REV-2, Chapter 7.

HUD also requires that a quality control review covering loan origination and servicing activities be periodically performed by the mortgagee/loan correspondent or by an external reviewer (usually a supervised financial institution). As part of the quality control review, the reviewer selects loans originated and serviced and tests them for compliance with HUD's requirements. The process the reviewer must follow when selecting a sample of loans to review is described in Chapter 7 of HUD, HB 4060.1 REV-2, Chapter 7.

Mortgagees must ensure that quality control reviews are performed on a regular and timely basis. The frequency of a review depends on the production volume. Chapter 7 of HUD HB 4060.1 REV-2 sets forth the scope of the reviews.

**Auditor Considerations.** The auditor should consider whether the client's quality control review procedures are effective in detecting noncompliance with HUD requirements. There should be a significant reduction in the risk of noncompliance by clients whose quality control review procedures are operating effectively.

The HUD audit guide, Paragraph 7-5A, presents procedures for testing compliance with the "Quality Control Plan" specific requirement. The procedures generally consist of making inquiries about, and examining documentation relating to, the quality control plan and the most recent quality control review performed by the mortgagee/loan correspondent or its external reviewer. Chapter 7 of the 2007 HUD audit guide adds a new requirement for the auditor to determine whether the mortgagee relies on internal or external quality control review, and sets forth specific procedures to perform, depending on which methodology the mortgagee employs.

### **Sponsor Responsibility Over Title II Loan Correspondents**

The 2007 revision to Chapter 7 of the HUD audit guide includes provisions whereby a sponsor may agree to assume responsibility of assuring that a Title II loan correspondent under its sponsorship is in compliance with HUD requirements. The HUD audit guide, Paragraph 7-5B, lists suggested procedures for testing the sponsor's compliance with the applicable HUD requirements. These procedures include testing the documentation supporting the sponsor's compliance reviews. Any compliance areas that are not assumed by the sponsor should be tested by the auditor in accordance with the Yellow Book standards. If the sponsor has not assumed responsibility for testing compliance, this compliance requirement is not applicable.

### **Branch Office Operations**

HUD Handbook 4060.1 REV-2 (Paragraph 2-11) requires that branch offices of the mortgagee/loan correspondent have adequate office space. Each branch office must have at least one employee and a branch manager who is assigned for that branch (Paragraph 2-12). The HUD audit guide, Paragraph 7-5C, lists suggested audit procedures for testing compliance with the "Branch Office" specific requirement.

### **Loan Origination**

The auditor should select a sample of files containing documentation of loans originated during the year and test them for compliance with HUD requirements. Exhibit 2-2 is a list of typical items contained in a loan file. If the client uses an independent third party to perform quality control testing over loan origination, the auditor may rely on that testing if—

- The auditor reviews the third party's procedures.
- The auditor retests a portion of the files tested by the third party.
- The third party's written reports indicate no significant discrepancies were identified.

### **Exhibit 2-2**

#### **Items Included in a Typical Loan File**

##### **HUD Forms**

Uniform Residential Loan Application (Form FNMA 1003)

Mortgage Credit Analysis Worksheet (Form HUD 92900-WS)

Important Notice to Homebuyers (Form HUD 92900-B)

Conditional Commitment/Direct Endorsement/Statement of Appraised Value (Form HUD-92800.5B)

## Other Information

Borrower's photo

Evidence of borrower's Social Security number

Verification of employment and most recent pay stub

Confirmation of the borrower's bank account balance

Most recent bank statements (usually for the past three months)

Federal income tax returns for the past two years (for self employed persons only)

Real estate sales contract

A list of all real estate owned by the borrower

Notice to borrower regarding possible refunds of Mortgage Insurance Premiums (MIP)

Verification of the borrower's payment history on previous mortgages

Uniform Residential Appraisal Report

Residential Mortgage Credit Report

Prepayment Disclosure Statement

\* \* \*

The HUD audit guide, Paragraph 7-5D, includes procedures for testing compliance with the "Loan Origination" specific requirement. The auditor should be aware that—

- a. When accepting loan applications, the mortgagee/loan correspondent may not set minimum mortgage amounts. (There are, however, *maximum* mortgage amounts established by HUD that must be observed.)
- b. Loan correspondents may sell loans they've originated only to their sponsors.
- c. Loan correspondents may not underwrite loans.
- d. The mortgagee/loan correspondent must reconcile conflicting information (e.g., amount and sources of income, employment status, etc.) provided by the applicant before submitting the loan application to the underwriter.

Instances of noncompliance that auditors often encounter in this area include the following:

- a. Failure to adequately establish the borrower's income.
- b. Failure to maintain complete loan files.

Mortgagees were previously required by Mortgagee Letter 95-36 to conduct "face-to-face" interviews with certain prospective borrowers. However, Mortgagee Letter 98-15 eliminates the "face-to-face" interview requirement provided the loan applicant chooses not to have one. (The lender *must ask* if the applicant wants a "face-to-face"

interview.) If the applicant wishes to have the “face-to-face” meeting, the lender should see that the meeting is conducted or the borrower may choose another lender. The 2007 revision to Chapter 7 of the HUD audit guide includes additional audit procedures when the loan applicant declines a face-to-face interview.

**Loan Underwriting—Single Family Loans.** Nonsupervised and supervised mortgagees serve as underwriters in the direct endorsement program, which provides the vast majority of single family mortgages. An important part of the underwriting process is performing a credit analysis of the borrower. HUD Handbooks 4000.2 and 4155.1 provide detailed guidance on credit analyses of loan applicants. Auditors should be aware of the following key aspects of credit analysis:

- a. A borrower's loan application generally is presumed to be acceptable, unless—
  - (1) The borrower's income indicates an inability to either close the loan or make monthly mortgage payments.
  - (2) The borrower's credit history demonstrates an inability to make payments in a timely manner.
  - (3) The borrower is precluded from program participation because of a delinquency on a current mortgage or a delinquency on debt owed to the federal government.
  - (4) The borrower is an investor in the mortgaged property that is contiguous to property containing seven or more rental units in which the borrower has a financial interest.
- b. If the borrower's loan application is rejected, the underwriter (HUD or the mortgagee) must send the borrower a Notice of Rejection.

## Loan Settlement

The HUD audit guide, Paragraph 7-5E, includes procedures for testing compliance with the “Loan Settlement” specific requirement. Instances of noncompliance that auditors most often encounter in this area include the following:

- a. Failing to submit a Mortgage Insurance Premium (MIP) payment to HUD within 15 days of the loan closing.
- b. Collecting fees from the borrower at closing that are not customary or reasonable in amount. For example, the mortgagee may not collect an origination fee in excess of 1% of the loan amount. HUD HB 4000.2, Paragraph 5-2, is a complete list of fees that HUD considers customary and reasonable.
- c. Failing to list all fees collected from the borrower on the loan settlement statement (Form HUD-1).

Chapter 7 of the 2007 HUD audit guide adds a requirement to review the accuracy of points and closing costs and to test whether differences may be due to discriminatory practices by the mortgagee.

## Loan Servicing

The HUD audit guide, Paragraph 7-5F, includes procedures for testing compliance with the “Loan Servicing” specific requirement. The compliance audit procedures address five loan servicing activities—

- a. Servicing delinquent and defaulted loans.
- b. Charging unallowable amounts to borrowers.
- c. Remitting Mortgage Insurance Premium (MIP) payments to HUD.
- d. Filing insurance claims with HUD.
- e. Servicing Home Equity Conversion mortgages.

The five loan servicing activities are discussed in the following paragraphs.

**Delinquent and Defaulted Loans.** The mortgagee's loan servicing responsibilities with respect to delinquent and defaulted loans are discussed in detail in HUD HB 4330.1. HUD HB 4330.1 makes the following key points:

- a. The mortgagee should have a system in place to identify delinquent mortgages and their payment status.
- b. Loan servicing staff must be accessible to borrowers.
- c. Acceptable collection methods include personal interviews, letters, and telephone calls.
- d. The borrower must conduct a personal interview with the delinquent borrower (or make reasonable efforts to meet with the borrower) no later than the 62nd day of delinquency.
- e. Records of collections activities must be retained for at least three years after the filing of the claim for insurance benefits.
- f. Foreclosure generally may not begin until three monthly installments are unpaid.

Chapter 7 of the 2007 HUD audit guide adds a requirement to review the mortgagee's acceptance of partial or late payments, and "obtain a representation letter from the auditee (mortgagee) concerning such procedures."

**Unallowable Charges.** HUD HB 4330.1 prohibits the following types of charges:

- a. Fees based on a percentage of the unpaid principal balance.
- b. Attorneys fees when the attorney is a salaried member of the mortgagee's staff.
- c. Fees to reimburse the mortgagee for telephone calls and property visits.

A mortgagee may charge the borrower a fee for processing checks returned as uncollectible. However, HB 4330.1, Paragraph 4-3, states that a check must be returned unpaid *twice* before it is deemed uncollectible.

Late charges are permitted, subject to the following limits:

- a. *Post-1976 Mortgages.* The maximum late charge is the lesser of 4% of the loan payment or an amount specifically stated in the note.
- b. *Pre-1977 Mortgages.* The maximum late charge is 2% of the loan payment.

**Mortgage Insurance Premiums.** Generally, mortgagors must remit the mortgage insurance premium (MIP) payment to HUD no later than the 10th day of the month following the month the premium is collected from the borrower.

**Insurance Claims.** HUD HB 4330.4 provides a detailed discussion of procedures the client should perform when processing insurance claims.

**Home Equity Conversions Mortgages.** The Home Equity Conversion Mortgages program offers adjustable rate or fixed rate mortgages to the elderly. Adjustable rate mortgages have a 2% annual cap and 5% lifetime cap on interest rate increases. Refer to Mortgagee Letter 00-10 for recent program changes.

## Escrow Accounts

Escrow funds received from mortgagors with HUD-insured mortgages must be segregated in a custodial account insured by either the Federal Deposit Insurance Corporation (FDIC) or the National Credit Union Administration (NCUA). Escrow funds must be used solely for the purpose for which they were collected. Escrow funds may not be used to:

- a. Pay a late charge owed to the mortgagee.

- b. Pay attorneys' fees in foreclosure actions that have not been completed.
- c. Pay fees for inspecting the mortgaged property.
- d. "Offset" mortgage delinquencies.

Escrow funds held in connection with HUD-insured mortgages may be commingled with funds relating to non-HUD insured mortgages. However, escrow funds may not be commingled with the mortgagee's operating account.

The HUD audit guide, Paragraph 7-5G, lists suggested procedures for testing compliance with the applicable HUD requirements. HUD HB 4330.1, Chapter 2, provides an in-depth discussion of escrow accounts.

### **Section 235 Assistance Payments**

Under Section 235, HUD assists borrowers in making their monthly mortgage payments by paying directly to the mortgagee a portion of the loan payment. To qualify for Section 235 assistance, borrowers must recertify their incomes annually, using Form HUD-93101. The mortgagee is required to verify the borrower's income and to compute the assistance payment using HUD-prescribed formulas. Chapter 10 of HUD HB 4330.1 provides detailed instructions on the recertification of the borrower and computation of the Section 235 assistance payments.

The mortgagee bills HUD for assistance payments each month using Form HUD-93102, *Mortgagee's Certification and Application for Assistance or Interest Reduction Payments*. The billings must be submitted to HUD's Office of Finance and Accounting, Accounts Payable Department, by the 20th day of the month before the month covered by the assistance payment. If the mortgagee overbills HUD for Section 235 assistance, the mortgagee generally must refund the overpayment to HUD and pay an interest penalty. The HUD audit guide, Paragraph 7-5H, lists suggested procedures for testing compliance with the applicable HUD requirements.

### **Federal Financial and Activity Reports**

The mortgagee is required to submit financial status and activity reports to HUD. Mortgagees use Form HUD-92068-A, *Monthly Delinquent Loan Report on Loans that are 90 or More Days Delinquent, Single Family Default Monitoring System*, to report loans in default as of the end of the month. This form must be mailed to HUD by the fifth working day of the month following the month covered by the report. Mortgagees use Form HUD-92068-C, *Distribution of Insured Mortgages Serviced and Delinquent by HUD Field Office Jurisdiction, Single Family Default Monitoring System*, to provide HUD with information about insured loans (including defaulted loans) as of the last day of each quarter. The form must be mailed by the fifth working day of the quarter following the quarter covered by the report.

Regulations implementing the Home Mortgage Disclosure Act (HMDA) require certain mortgagees to prepare a document called a loan application register. The loan application register lists detailed information about all loans originated by the mortgagor in the year, e.g., purpose of loan, amount, race and sex of the borrower, etc. Information and data from the preceding year are used to determine whether the mortgagee meets the reporting criteria. If required, mortgagees file the loan application register with HUD using Form FR HMDA-LAR. The form, which may be filed electronically, must be submitted to HUD no later than March 1st of the year following the year covered by the report. The HUD audit guide, Paragraph 7-5I, lists suggested procedures for testing compliance with the applicable HUD requirements.

### **Kickbacks**

HUD HB 4060.1 REV-2, Paragraph 2-22, states that a mortgagee is prohibited from:

- Paying a referral fee to any person or organization that refers a borrower to the mortgagee.
- Making a gift or gratuity in an amount that exceeds normal promotional expense.
- Advancing funds to a real estate agent, broker, mortgage broker, or loan packager as an advance against anticipated commissions on sales to be financed with a HUD-insured mortgage loan provided by the mortgagee.

- Making low or no interest loans to a real estate agent, broker, mortgage broker, loan packager, builder, or other party from whom the mortgagee accepts proposals involving HUD-insured mortgagees.
- Paying any compensation or fee prohibited by the Real Estate Settlement Procedures Act (RESPA). The RESPA regulations at 24 CFR Part 3500.14 include an in-depth discussion of prohibited transactions.
- Paragraph 2-22 of HUD HB 4060.1 REV-2 provides a list of HUD handbooks and mortgagee and circular letters that provide specific guidance about the fees permitted under different program policies.

The HUD audit guide, Paragraph 7-5J, lists suggested procedures for testing compliance with the applicable HUD requirements.

### **Mortgagee Approval Requirements**

Mortgagees and loan correspondents apply for approval to participate in HUD programs by filing an application form with the Lender Approval and Recertification Division at HUD Headquarters. The Lender Approval and Recertification Division is responsible for approving mortgagees for participating in HUD mortgage insurance programs and maintaining a record of all approved mortgagees on the Department's Institution Master File. Detailed instructions for the application are contained in Chapters 2 and 3 of *FHA Title II Mortgagee Approval Handbook* (HB 4060.1 Rev 2). Once accepted, entities must recertify annually with HUD to continue participating in HUD loan programs. The HUD audit guide, Paragraph 7-5K, presents suggested procedures for testing compliance with the "Mortgagee Approval Requirements" specific requirement. The compliance audit procedures address three areas:

- a. Minimum net worth requirements.
- b. Liquidity.
- c. Fidelity bond coverage and errors and omissions coverage.

Chapter 7 of the 2007 HUD audit guide adds a requirement for the auditor to (a) report noncompliance with required levels for adjusted net worth, liquid assets, fidelity bond coverage and errors and omissions bond in the report on compliance; (b) test filing of annual verification report and payment of renewal fee; and (c) test compliance in reporting any quarterly loss in excess of 20 percent.

**Minimum Net Worth Requirement.** Nonsupervised mortgagees and loan correspondents must have an "adjusted net worth" that exceeds amounts established by HUD. *Adjusted net worth* is the net worth per the balance sheet, less assets that HUD considers unacceptable for purposes of determining the mortgagee's compliance with the net worth requirements. Paragraph 7-6B of the HUD audit guide provides a list of "unacceptable assets."

Minimum net worth requirements that HUD has established for nonsupervised mortgagees and loan correspondents are presented in Exhibit 2-3.

The HUD audit guide requires an entity having an adjusted net worth deficiency to disclose, in its corrective action plan, an explanation of steps taken to correct the deficiency.

**Liquid Asset Requirement.** HUD HB 4060.1 REV-2, at Paragraph 2-6, states that all nonsupervised mortgagees and loan correspondents must maintain liquid assets that equal or exceed the lesser of the following:

- a. 20% of the entity's adjusted net worth, or
- b. \$100,000.

HUD HB 4060.1 REV-2 states that liquid assets consist of cash, cash equivalents, and marketable securities. Mortgages held for resale loans and lines of credit are not considered liquid assets for this requirement.

**FHA Approved Lenders.** FHA loan origination services must be performed by an FHA-approved lender or FHA-approved mortgage broker (loan correspondent). In addition to obtaining general approval as an FHA lender,



a mortgagee must meet specific requirements for its particular mortgagee type (for example, supervised, unsupervised, Title I or Title II) depending on the type of loans the mortgagee plans to originate. An FHA approved lender would then be subject to the specific compliance requirements applicable to its particular mortgagee type. Mortgagee Letter 2008-17 lists the origination functions and services that FHA requires to be performed by an approved lender or loan correspondent. Details on the requirements for initial and continuing FHA approval are contained in Chapter 2 of HB 4060.1 Rev 2.

**Fidelity Bond Coverage and Errors and Omissions Coverage.** Nonsupervised mortgagees are required to maintain fidelity bond coverage of at least \$300,000 and errors and omissions coverage of at least \$300,000. Loan correspondents are not required to maintain fidelity bond and errors and omissions coverage.

### Exhibit 2-3

#### Minimum Net Worth Requirements for Nonsupervised Mortgagees and Loan Correspondents<sup>a</sup>

##### Nonsupervised Mortgagees

1. Nonsupervised mortgagees that participate solely in multifamily programs must have an adjusted net worth<sup>b</sup> of at least \$250,000.
2. All other types of nonsupervised mortgagees (including sponsors of loan correspondents) must have an adjusted net worth that equals or exceeds the lesser of the following:
  - a. \$250,000 plus 1% of the dollar amount of insured mortgages that the mortgagee originated, purchased, and serviced during the prior fiscal year in excess of \$25 million, or
  - b. \$1 million.

##### Loan Correspondents

1. Loan correspondents must have an adjusted net worth that equals or exceeds the lesser of the following:
  - a. \$63,000 plus \$25,000 for each branch office, or
  - b. \$250,000.

SOURCE: HUD Handbook 4060.1 REV-2, *FHA Title II Mortgagee Approval Handbook*, Paragraph 2-5.

##### Notes:

- <sup>a</sup> Entities that participate in GNMA's mortgaged-backed securities program must meet additional net worth requirements. Auditors should refer to Chapter 6 of the HUD audit guide for guidance.
- <sup>b</sup> *Adjusted net worth* is the net worth per the balance sheet, less assets that HUD considers unacceptable for purposes of determining the mortgagee's compliance with the net worth requirements. Paragraph 7-6B of the HUD audit guide provides a list "unacceptable assets."

\* \* \*

## TITLE I NONSUPERVISED LENDERS AND LOAN CORRESPONDENTS SPECIFIC REQUIREMENTS

Title I loans are used primarily for property improvements or for purchases of manufactured homes (i.e., mobile homes). Title I loans may also be used for the purchase and installation of fire safety equipment in health care facilities and for the preservation of historic structures. As previously stated, the Title I program is smaller than the Title II program in terms of the number of program offerings and the number of participating institutions.

Implementing regulations at 24 CFR Part 201 contain the requirements under which the client can obtain insurance on Title I loans. Implementing regulations at 24 CFR Part 202 establish minimum standards and requirements for the approval of financial institutions to participate in the Title I program.

### HUD Handbooks

On September 1, 2006, HUD released a revision to Chapter 8 of the HUD audit guide, which was effective for audits for entities with fiscal years ending on or after December 31, 2006. The significant changes in the new chapter include the following:

- Requirements for reporting instances of noncompliance are clarified (Paragraph 8-4A).
- Electronic reporting requirements are added (Paragraphs 8-4B and 8-4C).
- Compliance requirements and suggested audit procedures are added, clarified, or revised (Section 8-5).
- An audit requirement regarding the annual computation of adjusted net worth was added. Also, a listing of unacceptable assets for computation of net worth is provided (Paragraph 8-6C).
- A section on reporting audit findings is added (Section 8-7).

Each significant revision in Chapter 8 of the HUD audit guide has been denoted by HUD with an asterisk at the beginning and at the end of the new or revised material.

The HUD audit guide lists HUD Handbook 4700.2, *Title I Lender Approval Handbook* (updated September 1995), and HUD Handbook 1060.2, REV-6 *Title I Property Improvement and Manufactured Home Loan Regulations, 24 CFR Parts 201 and 202* (updated June 1996), as the primary sources of information on Title I programs.

### Specific Requirements Applicable to Title I Nonsupervised Lenders and Loan Correspondents

Chapter 8 of the HUD audit guide identifies eight specific compliance requirements applicable to nonsupervised lenders and loan correspondents that participate in Title I programs:

- a. Branch Office Operations.
- b. Loan Origination.
- c. Loan Disbursement.
- d. Loan Servicing.
- e. Eligible Fees and Charges.
- f. Federal Financial Reports.
- g. Financial Approval Requirements.
- h. Quality Control Plan.

The HUD audit guide, Paragraphs 8-5A through 8-5H, lists procedures for testing compliance with the specific requirements. The HUD audit guide's procedures were developed directly from the requirements of HUD Handbook 1060.2 REV-6.

Chapter 8 of the 2007 HUD audit guide at Paragraph 8-6A adds a requirement for the auditor to report noncompliance with the required levels of adjusted net worth. Unacceptable assets for the computation of adjusted net worth are listed in Paragraph 8-6C of the HUD audit guide.

The HUD audit guide refers to, but does not address in any detail, several parts of the *Code of Federal Regulations* (CFR) relating to the "loan origination," "loan disbursement," and "eligible fees and charges" specific requirements. Key provisions of the CFR are summarized in the following paragraphs.

### **Loan Origination**

The HUD audit guide, Paragraph 8-5B, states that auditors should compare the lender's procedures for processing loan applications and evaluating the borrower's creditworthiness with the requirements of 24 CFR 201.22. According to 24 CFR 201.22, the lender should have the following information on file for each prospective borrower:

- a. Credit application.
- b. Verification of the borrower's social security number.
- c. Documentation verifying the borrower's current income and employment.
- d. Credit report.
- e. Verification that the borrower has not previously defaulted on a government-guaranteed loan.
- f. A list of specific funding sources to be used by the borrower for his or her down payment. This information is required only for loans that exceed \$5,000, and only when the down payment exceeds 5% of the loan.

24 CFR 201.22 requires the lender to determine that the amount spent by the borrower on "housing expense" does not exceed an amount established by HUD. Generally, housing expense includes loan payments, property taxes, and mortgage insurance. Title I Letter TI-428, issued July 22, 1994, states that housing expense cannot exceed 31% of income.

Also, the lender must determine that the borrower's "total fixed expenses" do not exceed 43% of income. Generally, total fixed expenses include housing expense plus other expenses of a recurring nature such as car loan payments, child care, and alimony.

### **Loan Disbursement**

**Borrower Eligibility and Use of Loan Proceeds.** The HUD audit guide, Paragraph 8-5C, states that auditors should review the lender's procedures for determining borrower eligibility and for determining whether the loan proceeds are used for the intended purpose. The regulations governing borrower eligibility and the use of loan proceeds are found in two parts of the CFR:

- a. For property improvement loans, the regulations governing borrower eligibility and use of loan proceeds are found at 24 CFR 201.20.
- b. For manufactured home loans, the regulations governing borrower eligibility and use of loan proceeds are found at 24 CFR 201.21.

To be eligible for a property improvement loan, the borrower generally must have at least a 50% ownership interest in the property being financed. Also, for property improvement loans over \$15,000, the borrower's equity in the property generally must equal or exceed the amount being financed. Loan proceeds may be used only to finance improvements to the borrower's principal residence. Improvements HUD deems to be luxury items, such as swimming pools and lawn sprinkler systems, cannot be financed with a property improvement loan.

To be eligible for a manufactured home loan, the borrower generally must hold a “fee simple title” to the manufactured home and lot. Fee simple title means the borrower’s ownership interest in the property is not encumbered by any restrictions or conditions. Loan proceeds may be used to purchase or refinance the home and lot. Loan proceeds may not be used to finance construction of a garage or patio or to purchase furniture for the home.

**Loan Documentation.** The HUD audit guide, Paragraph 8-5C further states that the lender’s disbursement of loan proceeds “must be adequately documented in the lender’s file.” In the case of property improvement loans, adequate documentation usually consists of the following:

- a. Evidence that the borrower meets the eligibility criteria described above. That is, the borrower has at least 50% ownership interest in the property and, for property improvement loans over \$15,000, the borrower has equity in the property that equals or exceeds the amount being financed.
- b. Evidence that the borrower holds a valid title to the property.
- c. Evidence that the lender approved the borrower’s agreement with the construction contractor.

In the case of manufactured home loans, documentation usually contains the following items:

- a. Evidence that the borrower meets the eligibility criteria described above. That is, the borrower holds a “fee simple title” to the manufactured home and lot.
- b. A copy of the purchase agreement.
- c. A copy of the invoice the borrower received from the manufactured home dealer, and a list of all other fees paid by the borrower in connection with the purchase of the home.
- d. The note and security agreement.
- e. Certifications from the borrower. The borrower must certify that:
  - (1) The home is the borrower’s principal residence.
  - (2) The home will not be removed from the lot without the lender’s approval.
  - (3) The home will remain on the lot for at least six months. (This certification is needed only when the loan proceeds are used to purchase both a home and lot.)
  - (4) Funds for the down payment were not borrowed from the manufactured home dealer.
- f. Certifications from the dealer that the home has been inspected and is structurally sound.

### **Eligible Fees and Charges**

24 CFR 201.25(a) allows the borrower to charge an origination fee. Title I Letter TI-440 (May 2, 1996) lists all fees and charges allowed in the program. (Title I letters can be accessed at HUD’s online information and resources repository at <http://www.hudclips.org>.) For example, the maximum origination fee the lender may charge is 5% of the loan amount. The HUD audit guide, at Paragraph 8-5H, lists suggested procedures for testing compliance with the applicable HUD requirements. These procedures include testing whether fees and charges are within limits allowed in Letter TI-440, and testing whether differences may be due to discriminatory practices.



**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

25. In accordance with provisions in the HUD audit guide, a sponsor may agree to assume the responsibility of assuring that a Title II loan correspondent under its sponsorship is in compliance with HUD requirements. Which of the following statements is accurate regarding testing of any compliance areas that are not assumed by the sponsor?
- a. Those compliance areas not tested by the sponsor need not be tested by the auditor.
  - b. Those compliance areas not tested by the sponsor should be tested by the auditor.
26. Which of the following statements regarding a quality control plan for Title II nonsupervised mortgagees and loan correspondents is accurate?
- a. HUD requires only nonsupervised mortgagees to maintain a quality control plan.
  - b. The quality control plan can be written or verbal.
  - c. The quality control plan must be a routine function of each mortgagee's origination and servicing operations.
  - d. The quality control function does not need to be independent from the origination and servicing functions.
27. The auditor may rely on quality control testing over loan origination performed by an independent third party based on three actions/results. Which of the following is one of those actions/results that make reliance on third party testing possible?
- a. The auditor reviews the third party's procedures.
  - b. The auditor retests all files tested by the third party.
  - c. The third party's written reports indicate no discrepancies were identified.
28. One example of evidence of noncompliance with the "Loan Settlement" specific requirement found in the HUD audit guide, Paragraph 7-5E, is failing to submit a Mortgage Insurance Premium (MIP) payment within \_ of the loan closing.
- a. 15 days.
  - b. 30 days.
29. Allowable loan charges include which of the following?
- a. Fees for processing checks returned as uncollectible.
  - b. Fees based on a percentage of the unpaid principal balance.
  - c. Attorneys fees when the attorney is a salaried member of the mortgagee's staff.
  - d. Fees to reimburse the mortgagee for telephone calls and property visits.

30. Escrow funds from mortgagors with HUD-insured mortgages may be used to:
- a. Pay a late charge owed to the mortgagee.
  - b. Pay fees for inspecting the mortgaged property.
  - c. "Offset" mortgage delinquencies.
  - d. Pay attorneys' fees in completed foreclosure actions.
31. Using Form HUD-93102, *Mortgagee's Certification and Application for Assistance or Interest Reduction Payments*, the mortgagee bills HUD for Section 235 assistance payments. The billings must be submitted to HUD by the \_\_\_\_\_ prior to the month covered by the assistance payment.
- a. 20th day of the month.
  - b. End of the month.
32. Who of the following are required to maintain fidelity bond coverage of at least \$300,000?
- a. Nonsupervised mortgagees.
  - b. Loan correspondents.
33. Which of the following is not one of the eight specific compliance requirements identified in the HUD audit guide applicable to nonsupervised lenders and loan correspondents that participate in Title I programs?
- a. Loan origination.
  - b. Loan disbursement.
  - c. Kickbacks.
  - d. Financial approval requirements.
34. The borrower's ownership interest in the property must not be encumbered by any restrictions or conditions to be eligible for which of the following types of loans?
- a. Property improvement loan.
  - b. Manufactured home loan.



## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

25. In accordance with provisions in the HUD audit guide, a sponsor may agree to assume the responsibility of assuring that a Title II loan correspondent under its sponsorship is in compliance with HUD requirements. Which of the following statements is accurate regarding testing of any compliance areas that are not assumed by the sponsor? **(Page 146)**
- a. Those compliance areas not tested by the sponsor need not be tested by the auditor. [This answer is incorrect. All compliance areas must be tested for compliance with HUD requirements.]
  - b. Those compliance areas not tested by the sponsor should be tested by the auditor. [This answer is correct. Any compliance areas the sponsor does not assume responsibility for testing should be tested by the auditor based on Yellow Book requirements.]**
26. Which of the following statements regarding a quality control plan for Title II nonsupervised mortgagees and loan correspondents is accurate? **(Page 147)**
- a. HUD requires only nonsupervised mortgagees to maintain a quality control plan. [This answer is incorrect. HUD requires that both nonsupervised mortgagees and loan correspondents maintain a quality control plan.]
  - b. The quality control plan can be written or verbal. [This answer is incorrect. The quality control plan must be in writing.]
  - c. The quality control plan must be a routine function of each mortgagee's origination and servicing operations. [This answer is correct. HUD requires that quality control be a prescribed and routine function of each mortgagee's origination and servicing operations.]**
  - d. The quality control function does not need to be independent from the origination and servicing functions. [This answer is incorrect. The quality control function must be independent from the origination and servicing functions.]
27. The auditor may rely on quality control testing over loan origination performed by an independent third party based on three actions/results. Which of the following is one of those actions/results that make reliance on third party testing possible? **(Page 148)**
- a. The auditor reviews the third party's procedures. [This answer is correct. One of three actions the auditor must take to be confident of the quality control testing over loan origination performed by an independent third party is for the auditor to review the third party's procedures.]**
  - b. The auditor retests all files tested by the third party. [This answer is incorrect. The auditor may rely on quality control testing over loan origination performed by an independent third party if three actions/results are present, one being that the auditor retests *a portion* of the files tested by the third party.]
  - c. The third party's written reports indicate no discrepancies were identified. [This answer is incorrect. In order for the auditor to be able to rely on quality control testing by an independent third party, it is necessary that the third party's written reports indicate no *significant* discrepancies were identified.]

28. One example of evidence of noncompliance with the "Loan Settlement" specific requirement found in the HUD audit guide, Paragraph 7-5E, is failing to submit a Mortgage Insurance Premium (MIP) payment within \_ of the loan closing. **(Page 150)**
- a. **15 days. [This answer is correct. The HUD audit guide requires submittal of a MIP payment within 15 days of the loan closing.]**
  - b. 30 days. [This answer is incorrect. A MIP payment cannot be submitted as long as 30 days after the loan closing date.]
29. Allowable loan charges include which of the following? **(Page 151)**
- a. **Fees for processing checks returned as uncollectible. [This answer is correct. HUD HB 4330.1, Paragraph 4-3, states that a mortgagee may charge the borrower a fee for processing checks returned as uncollectible, but such checks must be returned unpaid twice before being considered uncollectible.]**
  - b. Fees based on a percentage of the unpaid principal balance. [This answer is incorrect. Fees based on a percentage of the unpaid principal balance are unallowable charges.]
  - c. Attorneys fees when the attorney is a salaried member of the mortgagee's staff. [This answer is incorrect. HUD prohibits attorneys fees when the attorney is a salaried member of the mortgagee's staff.]
  - d. Fees to reimburse the mortgagee for telephone calls and property visits. [This answer is incorrect. HUD HB 4330.1 prohibits fees to reimburse the mortgagee for telephone calls and property visits.]
30. Escrow funds from mortgagors with HUD-insured mortgages may be used to: **(Page 152)**
- a. Pay a late charge owed to the mortgagee. [This answer is incorrect. A late charge that is owed to the mortgagee cannot be paid from escrow funds.]
  - b. Pay fees for inspecting the mortgaged property. [This answer is incorrect. Escrow funds must be used for the purpose for which they were collected. Escrow funds are not collected specifically to pay for inspecting mortgaged property.]
  - c. "Offset" mortgage delinquencies. [This answer is incorrect. Mortgage delinquencies may not be "offset" using escrow funds since escrow funds would not have been collected for delinquencies that could not have been anticipated at that time.]
  - d. **Pay attorneys' fees in completed foreclosure actions. [This answer is correct. Escrow funds may be used to pay attorneys' fees in completed foreclosure actions. However, they may not be used to pay attorneys' fees in foreclosure actions that have not been completed.]**
31. Using Form HUD-93102, *Mortgagee's Certification and Application for Assistance or Interest Reduction Payments*, the mortgagee bills HUD for Section 235 assistance payments. The billings must be submitted to HUD by the \_\_\_\_\_ prior to the month covered by the assistance payment. **(Page 152)**
- a. **20th day of the month. [This answer is correct. In order to receive Section 235 assistance payments, the mortgagee must submit billings to HUD not later than the 20th day of the month prior to the month covered by the assistance payment.]**
  - b. End of the month. [This answer is incorrect. The billings for Section 235 assistance payments must be submitted prior to the 21st day of the month prior to the month covered by the assistance payment.]

32. Who of the following are required to maintain fidelity bond coverage of at least \$300,000? **(Page 154)**
- a. **Nonsupervised mortgagees. [This answer is correct. Nonsupervised mortgagees are required to maintain fidelity bond and errors and omissions coverage of at least \$300,000 each.]**
  - b. Loan correspondents. [This answer is incorrect. Loan correspondents are not required to maintain fidelity bond or errors and omissions coverage.]
33. Which of the following is not one of the eight specific compliance requirements identified in the HUD audit guide applicable to nonsupervised lenders and loan correspondents that participate in Title I programs? **(Page 155)**
- a. Loan origination. [This answer is incorrect. Loan origination is one of the specific compliance requirements applicable to nonsupervised lenders and loan correspondents that participate in Title I programs, and also a specific compliance requirement applicable to nonsupervised mortgagees and loan correspondents or their sponsors that participate in Title II programs.]
  - b. Loan disbursement. [This answer is incorrect. One of the eight specific compliance requirements identified in the HUD audit guide applicable to nonsupervised lenders and loan correspondents that participate in Title I programs is loan disbursement.]
  - c. **Kickbacks. [This answer is correct. Kickbacks are one of the specific compliance requirements associated with participation in Title II programs, but not with Title I programs.]**
  - d. Financial approval requirements. [This answer is incorrect. Financial approval requirements is another of the eight specific compliance requirements applicable to nonsupervised lenders and loan correspondents that participate in Title I programs.]
34. The borrower's ownership interest in the property must not be encumbered by any restrictions or conditions to be eligible for which of the following types of loans? **(Page 157)**
- a. Property improvement loan. [This answer is incorrect. To be eligible for a property improvement loan, the borrower generally must have at least a 50% ownership interest in the property being financed.]
  - b. **Manufactured home loan. [This answer is correct. To be eligible for a manufactured home loan, the borrower generally must hold a "fee simple title" to the manufactured home and lot. Fee simple title means the borrower's ownership interest in the property is not encumbered by any restrictions or conditions.]**



**EXAMINATION FOR CPE CREDIT****Lesson 2 (HUDTG092)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

19. A financial institution that lends or invests funds in real estate mortgages as its principal activity and is required to have an audit performed in accordance with the HUD audit guide is a:
- a. *Supervised* mortgagee.
  - b. *Nonsupervised* mortgagee.
  - c. Do not select this answer choice.
  - d. Do not select this answer choice.
20. Which of the following programs provide financing to owners of single family and multifamily housing?
- a. Title II Programs.
  - b. Title I Programs.
  - c. Do not select this answer choice.
  - d. Do not select this answer choice.
21. Of the following terms, which one is correctly defined?
- a. *Direct Endorsement Program*. A HUD program that allows nonsupervised mortgagees and supervised mortgagees to underwrite and close loans for multifamily housing without prior HUD approval.
  - b. *Sponsor*. A sponsor can be either a nonsupervised mortgagee or a supervised mortgagee.
  - c. *Single Family Home*. Housing that consists of five dwelling units or less.
  - d. *Multifamily Housing*. Housing that consists of six dwelling units or more.
22. If a mortgagee originates an aggregate of FHA-insured loans exceeding \_\_\_\_\_ during the audit period, such action is considered a major program.
- a. \$200,000.
  - b. \$250,000.
  - c. \$300,000.
  - d. \$350,000.
23. All Title I and Title II nonsupervised mortgagees, loan correspondents, and lenders submit their financial and compliance data electronically to HUD using the Internet-based Lender Assessment Subsystem (LASS). The LASS template data is required to be submitted to HUD within \_\_\_\_\_ of the client's fiscal year end.
- a. 30 days.
  - b. 60 days.

- c. 90 days.
  - d. 120 days.
24. Which of the following is **not** one of the 11 specific compliance requirements identified in the HUD audit guide applicable to nonsupervised mortgagees and loan correspondents or their sponsors that participate in Title II programs?
- a. Quality control plan.
  - b. Branch office operations.
  - c. Eligible fees and charges.
  - d. Loan servicing.
25. Quality control reviews of the client's loan origination and servicing activities applicable to Title II nonsupervised mortgagees and loan correspondents must be performed how frequently?
- a. At least every 30 days.
  - b. At least every 45 days.
  - c. At least every 60 days.
  - d. Frequency depends on production volume.
26. HUD requires that branch offices of the Title II nonsupervised mortgagees and loan correspondents have adequate office space and at least \_\_\_\_\_ and a branch manager who is assigned for that branch.
- a. One employee.
  - b. Two employees.
  - c. Three employees.
  - d. Four employees.
27. Which of the following is accurate regarding procedures for testing compliance with the "Loan Origination" specific requirement in the HUD audit guide, Paragraph 7-5D?
- a. The mortgagee/loan correspondent may set minimum mortgage amounts when accepting loan applications.
  - b. Loan correspondents may sell loans they have originated to their sponsors or others.
  - c. Loan correspondents may underwrite loans under certain specified circumstances.
  - d. The mortgagee/loan correspondent must reconcile conflicting information from the applicant before submitting the loan application to the underwriter.
28. An important part of the underwriting process when providing single family mortgages is performing a credit analysis of the borrower. When auditors perform credit analysis, a borrower's loan application generally is presumed to be acceptable in which of the following circumstances?
- a. The borrower's income demonstrates an inability to either close the loan or make monthly mortgage payments.

- b. The borrower's credit history indicates an ability to make timely payments.
  - c. The borrower is precluded from program participation due to a delinquency on a current mortgage.
  - d. The borrower is an investor in the mortgaged property that is adjacent to property containing seven or more rental units and the borrower has a financial interest in those units.
29. Acceptable methods for collection of delinquent and defaulted loans include all of the following **except**:
- a. Personal interviews.
  - b. E-mails.
  - c. Letters.
  - d. Telephone calls.
30. Title I loans are used primarily to finance any of the following **except**:
- a. Property improvement.
  - b. Installing fire safety equipment in health care facilities.
  - c. Multifamily housing.
  - d. Preservation of historic structures.
31. Pursuant to Title I Letter TI-428, issued July 22, 1994, the amount spent by the borrower on "housing expense" cannot exceed \_\_\_\_\_ of income.
- a. 31%.
  - b. 33%.
  - c. 35%.
  - d. 37%.





# Lesson 3: Low-income Housing Tax Credit Projects

## INTRODUCTION

The Low-Income Housing Tax Credit (LIHTC) is a form of indirect federal subsidy that was established to encourage and finance new construction and rehabilitation of existing housing for low-income households. This federal income tax credit, administered by the states, is available to qualifying project owners for a 10-year period in addition to any assistance received through HUD's multifamily assistance programs. To qualify for the LIHTC, project owners must comply with the program's requirements for a 15-year period.

This lesson provides an overview of the LIHTC regulations, explains the services that auditors may provide for these projects, discusses compliance issues related to ongoing and initial project completion, and illustrates independent accountants reports for LIHTC projects.

### Learning Objectives:

Completion of this lesson will enable you to:

- Describe project requirements and tax credit calculation and define roles for auditors in the LIHTC program.
- Summarize compliance issues related to the initial completion of the LIHTC project as well as ongoing compliance responsibilities.

### Current Developments in Recently Enacted Legislation

CPAs providing services to LIHTC projects should be aware of the following recently enacted legislation that may affect such services.

**The American Recovery and Reinvestment Act of 2009.** The purpose of the American Recovery and Reinvestment Act (the Recovery Act) is to jumpstart the nation's ailing economy, with a primary focus on creating and saving jobs in the near term. Enacted in February 2009, the Recovery Act provides almost \$800 billion in stimulus funds, of which approximately \$13.6 billion is allocated for projects and programs administered by HUD. This funding is an important step in achieving the goal of providing more jobs while providing quality, affordable housing options for low-income families at a time when those options are needed more than ever. These federal funds are intended to supplement existing federal programs, create new programs, or provide more broad fiscal relief. Most of the Recovery Act funds administered by HUD will be passed through to state and local governments and public and Indian housing authorities. The Recovery Act will have a significant impact on the Low Income Housing Tax Credit (LIHTC) program by appropriating \$2.25 billion to fund the *Tax Credit Assistance Program* (TCAP)<sup>FN</sup> which will provide capital investments in stalled LIHTC developments.

**Tax Credit Assistance Program (TCAP).** The current economic and financial crisis has created significant challenges for the construction industry, particularly residential construction. One of the by-products of this crisis has been the freezing of investments in the low income housing tax credit (LIHTC) market. Many multifamily projects that benefit from HUD multifamily programs are structured to qualify for the LIHTC. On June 30, 2009 HUD announced that it is approving plans submitted by state housing finance agencies for \$1,035,322,485 to jump start affordable housing programs in states throughout the country that are currently stalled due to the economic recession. Funded through the Recovery Act, HUD's new Tax Credit Assistance Program (TCAP) will allow 26 state housing finance agencies to resume funding of affordable rental housing projects across the nation while stimulating employment in the hard-hit construction trades. The 52 State Housing Credit Agencies that administer the Low-Income Housing Tax Credit Program are the only eligible applicants (the 50 states plus the District of Columbia and the Commonwealth of Puerto Rico). No other organizations, entities, or individuals are eligible for funding.

Since the contraction of the credit market, and as traditional investors remain on the sidelines, the value of tax credits has plummeted. Consequently, as many as 1,000 projects (containing nearly 150,000 units of housing) are on hold across the country. HUD is awarding these TCAP grants to complete construction of qualified housing projects that will ultimately provide affordable housing to an estimated 35,000 households nationwide. Since a major purpose of this program is job creation, the Recovery Act establishes ambitious deadlines for expenditure of

grant funds and requires state housing credit agencies to give priority to projects that can begin immediately and be completed by February 16, 2012. Additional grants will follow.

The development of new multifamily affordable housing and the rehabilitation of existing multifamily affordable housing under TCAP often includes HUD funding via:

- An insured HUD mortgage.
- A risk-sharing loan.
- A capital advance under either the Section 202 or Section 811 program.
- For a rehabilitation project, the assumption of a Section 8 project-based assistance contract.
- For a former Section 236 project, the “decoupling” of the Section 236 IRP, which requires the purchaser to execute a USE Agreement.

The Recovery Act specifies that certain housing-related statutory provisions will apply to recipients, including project owners, of TCAP funds including the following:

- Davis-Bacon wage requirements.
- Environmental review under HOME.
- Fair Housing Act.
- Uniform Relocation Act.
- Title VI of the Civil Rights Act.
- Section 504 of the Rehabilitation Act.

A significant aspect of the Recovery Act is the reporting requirement designed to provide transparency and accountability for expenditure of Recovery Act funds. OMB has issued detailed guidance on the overall reporting requirements. HUD will issue supplemental guidance on LIHTC program requirements including recordkeeping, reporting and applicable federal grant requirements as they become available. Auditors can access information about TCAP, reporting requirements, and links to relevant resources on HUD's website at [http://portal.hud.gov/portal/page?\\_pageid=153,7973386&\\_dad=portal&\\_schema=PORTAL](http://portal.hud.gov/portal/page?_pageid=153,7973386&_dad=portal&_schema=PORTAL).

**H.R. 3221, American Housing Rescue and Foreclosure Prevention Act.** On July 30, 2008, the President signed the American Housing Rescue and Foreclosure Prevention Act into law. This bill has been passed in the Senate and the House but has not been signed by the President. It is a package of housing stimulus measures that combines a number of amendments, including measures that would modernize the low-income housing tax credit (LIHTC) program. Among other things, the bill provides a 20-cent per capita LIHTC cap increase for 2008 and 2009 and increases the small state LIHTC minimum by 10 percent for those years. The rule can be accessed at [http://www.house.gov/apps/list/press/financialsvcs\\_dem/press050808.shtml](http://www.house.gov/apps/list/press/financialsvcs_dem/press050808.shtml).

**H.R. 5140, Economic Stimulus Act of 2008.** On February 13, 2008, the President signed the Economic Stimulus Act of 2008 into law. Some of the provisions of the bill may have a material impact on the affordable housing industry. The most significant provision is an additional depreciation allowance equal to 50% of the cost of personal property and land improvements placed in service on or after January 1, 2008 and before January 1, 2009, as well as for costs for land improvements incurred during 2008 for property placed in service before January 1, 2010. Details on this act can be found at [www.whitehouse.gov/jct/x-8-08.pdf](http://www.whitehouse.gov/jct/x-8-08.pdf).

**H.R. 3648, Mortgage Forgiveness Debt Relief Act (Debt Relief Act).** On December 20, 2007, the President signed the Debt Relief Act into law. Until it was passed, households comprised entirely of full time students could not qualify for low income housing. An amendment to the Debt Relief Act amends Section 42 of the Tax Reform Act

to allow a household comprised of a single parent and his or her children, all of whom are full-time students, to qualify for low-income housing as long as none are dependents of another individual. Details on this act can be found at <http://www.govtrack.us/congress/bill.xpd?bill=h110-3648>.

**H.R. 4440, Gulf Opportunity (GO) Zone Act of 2005 (GO Zone Act).** The GO Zone Act, which was enacted on December 22, 2006, provided tax incentives to individuals and businesses in certain presidentially declared disaster areas. The provisions of the act authorized the states to allocate certain tax incentives such as additional low-income housing tax credits (LIHTC) and tax-exempt bond financing. For these two provisions, existing tax incentives were extended, granting additional authority to GO Zone areas in addition to regular, annual allocations available to the affected states. Each eligible state was responsible for setting up an application process and selecting which qualified projects are to receive allocations up to each state's GO Zone allocation authority under the GO Zone act. Details on the act can be found at <http://www.govtrack.us/congress/bill.xpd?bill=h109-4440>.

**Notice 2007-66, Relief From Certain Low-income Housing Credit Requirements Due to Katrina.** In this notice, the IRS provided for an extension of time for the restoration of LIHTC projects located within the GO Zone that were damaged by Hurricane Katrina. Certain conditions apply and the relief does not extend beyond the calendar year 2009. The notice can be accessed at [www.irs.gov/irb/2007-34\\_IRB/ar12.html](http://www.irs.gov/irb/2007-34_IRB/ar12.html).

**Revenue Procedure 2007-4.** In 2007 the IRS issued Revenue Procedure 2007-54, which provides for temporary relief for project owners who have a carryover allocation for a building located in a major disaster area and the area is declared a major disaster area during the two-year period described in IRC Section 42(h)(1)(E)(i). The IRS will treat the owner as having satisfied the applicable placed in service requirement if the owner places the building in service no later than December 31 of the year following the two-year period.

Furthermore, if the project owner has a carryover allocation for a building located in a major disaster area, then the IRS will treat the owner as having satisfied the 10% basis requirement of IRC Section 42(h)(1)(E)(ii) if the owner incurs more than 10% of the owner's reasonably expected basis in the project (land and depreciable basis) no later than six months after the date that the owner would otherwise be required to meet the 10% basis requirement under IRS Regulation 1.42-6(a)(2)(i) and (ii). The project owner may obtain this carryover allocation relief only if the owner receives approval for the relief from the agency that issued the carryover allocation.

## LIHTC PROGRAM OVERVIEW AND ADMINISTRATION

### Legal Authorization

The LIHTC was created and authorized by Congress through the Tax Reform Act of 1986 as an incentive for private investors and developers to provide more affordable rental housing. Due to the 1983 elimination of the linkage of the Section 8 Housing Assistance Payments program with HUD-insured Section 221(d)(4) mortgages, the LIHTC program has become the primary vehicle for the development of low-income housing in the United States. Although the 1986 Act created the credit, it was only a temporary authorization that was not made permanent until the Omnibus Budget Reconciliation Act of 1993.

### Participants

The federal government allocates LIHTCs to each state based on a statutory amount per resident and the population of the state. The state tax credit allocation agency ("the state"), which is usually the state housing finance agency, then awards tax credit allocations to participating developers based on competition and criteria set forth in the state's housing qualified allocation plan. Unused credits are returned by the states to the federal government for future reallocation.

The developers typically sell the federal income tax credits to private investors, who use them on their federal income tax returns. Under this arrangement, the investors typically become limited partners of the developers' projects, providing project capital in exchange for the use of the credits. The developer has an obligation to the investor to ensure that the project complies with all requirements for the 15-year compliance period so that the credit is available to the investor for the entire 10-year credit period and that past credits are not recaptured.

## Credit Allocations and Bond Projects

As previously discussed, developers generally compete for an individual state's allocation of credits as determined by the state's population. These will be referred to as *competitively allocated credit projects*. However, an exception to this competitive system exists for projects that are financed with certain tax-exempt bonds. These bond volume cap projects are not subject to the state's credit allocation because they are subject to the state's separate annual volume cap on tax-exempt bond financing. Due to this cap, projects may still have to compete with other tax-exempt, bond-financed projects if the demand exceeds the cap.

## LIHTC PROJECT REQUIREMENTS AND CALCULATION OF TAX CREDIT

### Minimum Project Requirements

The states' housing allocation plans set forth minimum project requirements, including both federal requirements and specific state requirements, such as a higher percentage of low-income units, lower rents, or a longer compliance period. These requirements are generally documented in a regulatory agreement between the developer and the state. Each state must monitor compliance with its plan and report noncompliance to the federal government. The project must meet the following minimum provisions required by federal law to receive the low-income housing tax credit:

- a. Be new construction or rehabilitation expenditures on residential property.
- b. Maintain either—
  - (1) at least 20% of available units as rent restricted and occupied by households earning up to 50 percent or less of the area median gross income; or
  - (2) 40% as rent restricted and occupied by those earning up to 60% or less of the area median gross income.
- c. Restrict rents to 30% of the applicable income limitation above, either the 50% or 60% of area median gross income.
- d. Maintain habitability standards.
- e. Operate in compliance with the above requirements for a minimum of 15 years, longer if subject to an extended use agreement.

Projects not meeting the above requirements each year of the compliance period are subject to having their credits "recaptured," that is, repaid to the federal government.

### Tax Credit Calculation

The credit is computed by multiplying the qualified basis amount of the low-income housing by the applicable credit percentage (provided monthly by the federal government based on the date the project is placed in service). The qualified basis is the product of the low-income occupancy percentage multiplied by the eligible basis of the building. The federal government determines the appropriate tax credit percentages to subsidize the project cost over the life of the project. The tax credit percentage is either 30% or 70%, as follows:

- 30% subsidy is used for new construction that has additional federal subsidies or for the acquisition cost of an existing building.
- 70% subsidy is used for new construction without other federal subsidies.

### LIHTC Resources

Although there is no federal agency audit guide for LIHTC projects, like the HUD audit guide, auditors should understand the compliance requirements built into IRC Section 42, as well as any applicable state requirements. Exhibit 3-1 lists resources that will be useful to auditors of LIHTC projects.

### Exhibit 3-1

## Useful Resources Relating to Low-income Housing Tax Credit Projects

### Federal Government Resources

- IRC Section 42—Low-Income Housing Credit
- Treasury Regulations 1.42-1 through 1.42-17
- Joint Committee Report on the LIHTC
- *Market Segment Specialization Program—Low-Income Housing Credit—1999*. This audit techniques guide was developed by the IRS to support its personnel in identifying and developing issues related to IRC Section 42.

### Other

- *Low-Income Housing Tax Credit Handbook—2009 ed.* Authored by Jon E. Krabben Schmidt and Michael J. Novogradac of Novogradac & Company, LLP, a public accounting firm specializing in LIHTC projects, this book is a comprehensive reference manual covering all aspects of LIHTC development, valuation, and ongoing compliance. It can be ordered from the publisher, Thomson West, by calling (800) 344-5008 or by visiting **www.west.thomson.com**.

\* \* \*

### Additional Requirements

**TCAP Compliance.** Each project owner must enter into a TCAP written agreement with the state agency that includes a restrictive covenant to enforce all TCAP-specific and cross-cutting federal requirements. Specific requirements for the written agreement can be accessed at [http://portal.hud.gov/pls/portal/docs/PAGE/RECOVERY/PROGRAMS/TCAP\\_RESOURCES/TCAP-WRITTEN%20AGR%20RQMTS-ADMIN.PDF](http://portal.hud.gov/pls/portal/docs/PAGE/RECOVERY/PROGRAMS/TCAP_RESOURCES/TCAP-WRITTEN%20AGR%20RQMTS-ADMIN.PDF). Auditors should be alert for the issuance of further guidance on TCAP compliance and reporting requirements by monitoring the HUD website at [http://portal.hud.gov/portal/page?\\_pageid=153,7973386&\\_dad=portal&\\_schema=PORTAL](http://portal.hud.gov/portal/page?_pageid=153,7973386&_dad=portal&_schema=PORTAL).

**HOME Program.** Projects assisted via the HOME program will have additional income and rent restrictions as set forth in the HOME award. Although TCAP funds were appropriated under the HOME heading of the Recovery Act, HOME program requirements do not apply to TCAP funds.

**Exchange of “Unused” Tax Credits.** Under the Recovery Act, State housing agencies may exchange “unused” tax credits for grants from the Treasury. For each \$1 of credit exchanged, the state will receive a \$.85 grant. The amount of relinquished credit may not exceed 100% of unused 2008 credits or previously allocated credits returned to the state during 2009, and up to 40% of the 2009 state allocation.

**Additional State Agency Requirements.** In order to maximize points when competing for a credit allocation, project owners may have agreed to additional lower rent and income restrictions, increased number of low-income units, or a longer compliance period. These compliance provisions are set forth not only in statute and regulation, but also in the regulatory agreement required by the state.



## AUDITORS ROLES IN THE LIHTC PROGRAM

Audit requirements for low-income housing tax credit projects are usually determined by the language of the organizational agreement of the project owner (for example, the partnership agreement) or the mortgage. The partnership agreement usually requires an annual GAAS audit, especially for projects with 11 or more units.

Besides the financial statement audit, independent accountants may be engaged to perform several different services for the LIHTC project.

### Attest Services for Financial Projections

LIHTC projects are generally syndicated via limited partnerships through both private and public offerings. Investors and syndicators routinely require local project sponsors to create financial projections as part of the up-front analysis of the potential deal by both the syndicator and the investor, requiring the services of the auditor.

### Cost Certifications

IRC Section 42(m)(2)(B) requires states to consider the reasonableness of the developmental and operational costs of competitively allocated credit projects and bond volume cap projects when determining the housing credit dollar amount allocated to a project. IRS Regulation 1.42-17(a)(5) requires the taxpayer to submit a schedule of project costs prepared on the method of accounting used for federal income tax purposes that details the project's total costs as well as those costs that may qualify for inclusion in its eligible basis. That schedule of costs is commonly referred to as the cost certification or basis certification. The cost certification schedule must be audited if the project has more than 10 units, and states may require an audited schedule even if the project has fewer units. The audit of the schedule is referred to as a cost certification audit.

The cost certification audit must be conducted in accordance with generally accepted auditing standards, and only unqualified auditor's reports are acceptable. Bond-financed projects are subject to the same requirement. Each state provides instructions for the form and content of the schedule of project costs.

### Ten-percent Carryover Certifications

Competitively allocated credit projects are routinely neither completed nor placed in service during the year of the preliminary allocation. IRC Section 42(h)(1)(E) allows the credits to remain valid as long as (a) the qualified building is placed in service before the end of the second calendar year following the calendar year in which the allocation is made and (b) the taxpayer's basis at the end of the allocation year is more than 10% of the taxpayer's reasonably expected basis in the project upon completion. States must verify that this requirement is met. IRS Regulation 1.42-6c suggests that a state may require a project to obtain a written certification issued by either a CPA or an attorney, who examines eligible costs and attests that the 10% requirement was met.

### Attest Service for the 50% Test

If 50% or more of the aggregate basis of any building and the land on which the building is located is financed by tax-exempt financing, the entire project is eligible for credits [IRC Section 42(h)(4)(B)]. Conversely, if less than 50% is financed, the project will be awarded credits limited to the tax-exempt financed expenditures, absent further action by the project owner, such as applying for competitive credits using resources other than the proceeds of the tax-exempt bond. Accordingly, states require a certification by the project owner that the project satisfies the 50% test. Some states require an attestation report on this test.

### Partnership Tax Return

The project's auditor may also be engaged to prepare the partnership's federal income tax return.

### Cash Flow Verification

Ratings agencies and bond insurers often require an independent verification of the adequacy of projected cash flows to meet debt service requirements for bonds and payment of trustee and other expenses.



**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

35. The low-income housing tax credit (LIHTC) is computed by multiplying the qualified basis amount of the low-income housing by the applicable credit percentage that is provided by the federal government on a monthly basis and is based on the date the project is placed in service. The tax credit percentage subsidizes the project cost over the life of the project and is either 30% or 70%. 70% subsidy is used for which of the following?
- a. New construction without other federal subsidies.
  - b. The acquisition cost of an existing building.
  - c. New construction with additional federal subsidies.
36. LIHTC projects are generally syndicated by means of limited partnerships through:
- a. Only private offerings.
  - b. Both private and public offerings.
37. Bill Smith is an owner of five different low income housing projects. Each project consists of a building occupying one acre of land each. Only one of the buildings and the land it occupies has as much as 50% of the aggregate basis financed by tax-exempt financing. What percentage of that low income housing project is eligible for credits?
- a. 20%.
  - b. 50%.
  - c. 100%.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

35. The low-income housing tax credit (LIHTC) is computed by multiplying the qualified basis amount of the low-income housing by the applicable credit percentage that is provided by the federal government on a monthly basis and is based on the date the project is placed in service. The tax credit percentage subsidizes the project cost over the life of the project and is either 30% or 70%. 70% subsidy is used for which of the following? **(Page 180)**
- a. **New construction without other federal subsidies. [This answer is correct. For new construction that does not have other federal subsidies, the tax credit is 70%.]**
  - b. The acquisition cost of an existing building. [This answer is incorrect. 30% subsidy is used for the acquisition cost of an existing building.]
  - c. New construction with additional federal subsidies. [This answer is incorrect. For new construction that has additional federal subsidies, the tax credit percentage is 30%.]
36. LIHTC projects are generally syndicated by means of limited partnerships through: **(Page 182)**
- a. Only private offerings. [This answer is incorrect. LIHTC projects are generally syndicated by means of limited partnerships through private offerings and public offerings.]
  - b. **Both private and public offerings. [This answer is correct. The syndication of LIHTC projects generally occurs via limited partnerships using both public and private offerings.]**
37. Bill Smith is an owner of five different low income housing projects. Each project consists of a building occupying one acre of land each. Only one of the buildings and the land it occupies has as much as 50% of the aggregate basis financed by tax-exempt financing. What percentage of that low income housing project is eligible for credits? **(Page 182)**
- a. 20%. [This answer is incorrect. The percentage of the project eligible for credits is not based on the percentage of the total number of buildings owned.]
  - b. 50%. [This answer is incorrect. The percentage of the project eligible for credits is not the same as the percent age of the aggregate basis financed by tax-exempt financing]
  - c. **100%. [This answer is correct. If 50% or more of the aggregate basis of any building and the land on which the building is located is financed by tax-exempt financing, the entire project is eligible for credits pursuant to IRC Section 42(h)(4)(B).]**

## INITIAL COMPLETION OF THE LIHTC PROJECT—COMPLIANCE ISSUES

### Key Threshold Tests for Bond Cap Projects

The following discussion focuses on various tests that, if not met, would result in a material reduction in the final tax credit allocation for bond cap projects.

**Minimum Expenditure Test—IRC Section 147(d).** The proceeds from a private activity bond may not be used for the acquisition of existing property. However, IRC Section 147(d)(2) provides an exception for any building (including equipment) if the rehabilitation expenditures equal or exceed 15% of the portion of the cost of acquiring such building (and equipment) financed with the net proceeds of the issue. Rehabilitation expenditures refer to any amount properly chargeable to the capital account. If this threshold is not met, the tax-exempt bond issue does not meet the requirements of a *qualified* bond.

**The 95% Good Costs/Bad Costs Test—IRC Section 142(a).** IRC Section 142(a) indicates that a bond issue, the proceeds of which are used to provide for qualified residential rental projects, qualifies the bonds as tax-exempt bonds if 95% or more of the proceeds of the bonds are used for land, building, or other property that is functionally related and subordinate to the residential facility. These costs are *good* costs. Costs that do not qualify as good costs are *bad* costs. Bad costs include:

- a. Costs incurred prior to the date of bond inducement (except land and building costs);
- b. Partnership organizational costs;
- c. Bond issuance costs; and
- d. Loan origination fees amortizable over the permanent (versus construction) period of the tax-exempt bonds.

**50% Test—IRC Section 42(h)(4)(B).** A project financed with tax-exempt bonds must satisfy this threshold test in order to obtain a final allocation of credits based on the total eligible basis of the entire project. The test requires the following determinations: (a) the dollar amount of tax-exempt bond proceeds used to finance total project costs, and (b) the *aggregate basis* of the project, which is the eligible basis plus land.

Instructions for determining the amount of tax-exempt bond proceeds used to finance total project costs are set forth in IRS Regulation 1.42-1T(f)(ii). If the bond indenture or related document (such as the Tax Certificate and Agreement) provides an allocation, then the numerator would represent that allocation. In addition, the identification of tax-exempt bond proceeds used for *good* costs would be an appropriate resource. However, if the issuer is not consistent in making this allocation throughout the bond indenture or if the bond indenture does not provide an allocation, the proceeds of the issue will be allocated on a pro rata basis to all of the property financed by the issue, based on the relative weight of the property.

### Other Key Threshold Tests

**Residential Rental Property Test—IRC Section 168(e)(2).** Residential rental property is defined as any building or structure that derives 80% or more of its gross rental income from dwelling units.

**Minimum Rehabilitation Expenditures Test—IRC Section 42(e)(3).** For rehabilitation expenditures to qualify as a *separate new building*, IRC Section 42(e)(3) requires the expenditures during any 24-month period to equal or exceed the greater of 10% of the adjusted basis of the acquired building or \$3,000 or more for each low-income unit.

### Eligible Basis of Project

As previously noted, the low-income housing tax credit is calculated based on the *qualified basis* of the housing units serving the low-income tenants. IRC Section 42(c)(1) defines the qualified basis of a qualified low-income

building for a taxable year as an amount equal to the applicable fraction of the eligible basis of the building [determined under subsection (d)(5)], which means the cost attributable to the low-income housing. Thus, the determination of eligible basis is the overarching objective of the cost certification process.

IRC Section 42(d) provides four pages of definitions, exceptions, and special rules. What IRC Section 42(d) does *not* provide is a clear roadmap for the determination of eligible basis. However, the first section of a roadmap can be found in the Joint Committee Report on the Low-Income Housing Credit. It states that the eligible basis consists of costs of:

- a. New construction,
- b. Rehabilitation, or
- c. Acquisition of existing buildings acquired through a purchase and the cost of rehabilitation, if any, to such buildings incurred before the close of the first taxable year of the credit period.

Only the adjusted basis of the building may be included in the eligible basis. The adjusted basis is determined by taking into account the adjustments described in IRC Section 1016 [other than paragraphs (2) and (3) of IRC Section 1016(a), relating to depreciation deductions], including, for example, the basis adjustment provided in IRC Section 42(g) for any rehabilitation credits allowed under IRC Section 38. The cost of land is not included in the adjusted basis.

IRC Section 1016 provides another section of the roadmap to eligible basis by indicating that property should be adjusted for expenditures, receipts, losses, or other items properly chargeable to the capital account. This raises the following questions. Where is the statutory authority and regulatory standard for capital expenditures? What transactions are properly chargeable to capital account?

The statutory authority for capital expenditures is found in IRC Section 263, which states that no deduction shall be allowed for amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property. Relevant regulatory standards are found at IRS Regulation 1.263A-1—Uniform capitalization of costs; IRS Regulation 1.263A-2—Rules relating to property produced by the taxpayer; IRS Regulation 1.263A-8—Requirement to capitalize interest; and IRS Regulation 1.263A-9—The avoided cost method.

Having identified the authoritative Code and regulatory sections of the roadmap for the determination of eligible basis, the next step is to provide a description and analysis of the typical transactions that a project developer will incur in the process of the development of a qualifying low-income housing tax credit project. The objective is to provide the reader with (a) a checklist of the likely transactions and (b) recommended procedures for the determination of the cost as well as specific guidance regarding the eligibility of the transaction for eligible basis.

**Land.** Land cost or value is not includable in eligible basis, in part due to the explicit exception discussed in the Joint Committee Report on the Low-Income Housing Credit and because it is not depreciable property.

**Demolition.** Demolition costs are typically included within the scope of the construction contract.

**Legal Costs.** Arguably, legal fees associated with the negotiation of the purchase agreement would be properly allocated between land and building based on the relative fair market value of each.

**Rehabilitation.** In the California Final Cost Certification format, rehabilitation costs have five components. The California Tax Credit Allocation Committee requires the discrete presentation of costs for general requirements, overhead, and profit because the state's qualified allocation plan imposes limits on those costs. Furthermore, these rehabilitation costs include the direct costs of rehabilitation charged to the project by the general contractor *and* direct and indirect costs incurred by the project that are properly capitalizable pursuant to IRS Regulation 1.263A-1(e)(2) (for direct costs) and IRS Regulation 1.263A-1(e)(3)(ii) (for indirect costs). These costs may include maintenance and repairs, property management, administration, landscaping, and utilities paid on vacant units, all of which were incurred during rehabilitation. AIA Documents G702 and G703 (Contractor's Application and Certification for Payment and Continuation Sheet to G702) are the most common source documents to support actual costs incurred by the general contractor.

**Relocation Expenses.** Industry practice is to capitalize these costs into eligible basis, inasmuch as the relocation of the tenants was necessary to complete the process of the building rehabilitation.

**New Construction Costs.** The discussion above is also applicable to new construction. Unique new construction cost should be treated as follows:

- a. *Site Preparation*—Land preparation costs that are not inextricably associated with the building (that is, would not be replaced if the building were destroyed) are not includable in eligible basis.
- b. *Off-site Costs*—Developers of new construction projects will typically incur costs such as the creation of an access road, bridge, or tunnel or installation of sewer systems. Historically, these costs, when maintained by a governmental entity, were not included in eligible basis. However, IRS Regulation 1.263(a)-4(d)(8)—Certain Benefits Arising From the Provision, Production or Improvement of Real Property, provides under IRC Section 263A statutory authority to capitalize these transactions into depreciable (and therefore eligible) basis when the real property can reasonably be expected to produce significant economic benefits to the taxpayer even though it has been transferred to another entity.

**Architectural Fees for Design and Supervision.** These are direct costs associated with the new construction or rehabilitation and are properly capitalizable.

**Construction Interest, Loan, and Related Costs.** Construction interest, loan, and related costs should be treated as follows.

- a. *Construction Interest*—IRC Section 263A(f) provides the statutory authority for this tax accounting treatment, and Reg. 1.263A-9 provides instructions for implementation. In brief, the amount of interest to be capitalized is the interest cost to carry accumulated production expenditures during the production period of a unit of property. Furthermore, under this methodology, the amount of interest subject to capitalization may exceed the actual amount of interest incurred by the borrower. IRS Notice 88-99, paragraph IX(B)—Substituted Cost Method (1988-2, C.B. 422), provides instructions for substituting operating expenses for construction interest calculated under this method, which exceeds interest incurred by the borrower during the production period.
- b. *Construction Loan Fees*—Financing fees, including construction loan fees and legal and other fees associated with the fee, must be capitalized and amortized on a straight-line basis over the life of the related loan. If the fee is for a loan whose life includes all or part of the production period, the amortization attributable to the production period is properly capitalizable into depreciable basis. The general rule for treatment of construction loan fees, if one loan covers the construction period and the permanent finance period of the project, is to amortize all loan-related costs over the life of the loan, and capitalize into basis only the amount of amortization attributable to the construction period. Auditors may refer to the guidance provided in the IRS Technical Advisory Memorandum 200044005.
- c. *Credit Enhancement Application Fee and Bond Premium Fee*—These fees would receive the same eligible basis treatment as the construction loan fee.
- d. *Real Estate Taxes and Insurance*—Real estate taxes incurred before the inception of the production period may be capitalized if a IRC Section 266 election is made. Real estate taxes and insurance properly accrued during the production period would be capitalized in a manner consistent with construction interest.
- e. *Title and Recording*—These costs are capitalized into land for a new construction project.

**Permanent Financing.** Financing costs (net of amortization attributable to the production period) are classified as permanent financing costs and are not included in eligible basis.

**Legal Fees.** Legal counsel to the partnership (borrower) typically covers matters that could be allocated to land acquisition, building acquisition, entity organization, construction financing, permanent financing, and acquisition of investors. In the authors' experience, it is often most efficient to obtain a representation from the borrower's counsel regarding the allocation of legal fees.

**Reserves.** Examples of reserves include lease-up reserves, debt service reserves, and initial funding of the reserve for replacements. The amount of the required deposit is *not* allocable to eligible basis. However, because some states' qualified allocation provides for the "cap" on the developer fee at a percentage of total development costs, and the required deposits into the reserves are recognized as a component of total development costs, all required deposits into the reserves should be captured in the cost certification.

**Other Costs.** The following other costs should be treated as follows:

- a. *State Credit Allocation Agency Application/Monitoring Fees*—Industry practice has been to capitalize application fees and allocate application fees into eligible basis. However, Question 3 of Revenue Ruling 2004-82, issued in August 2004, specifically excludes application and allocation fees from eligible basis.
- b. *Local Development Impact Fees*—These fees are typically a component of total development costs for a new construction project, due to the need for expanded public improvements necessitated by the new development. Revenue Ruling 2002-9 instructs that impact fees must be capitalized under IRC Section 23A as indirect costs allocable to the new residential rental building.
- c. *Permit Processing Fees*—These fees are capitalized and allocated to eligible basis as provided for in IRS Regulation 1.197-2c(3).
- d. *Capital Fees*—In the industry, these are more commonly referred to as either cost of capital or syndication fees. They are a component of total development costs, but are not allocable to eligible basis. Furthermore, many credit allocation agencies (and syndicators) remove these fees from total development costs for the purpose of calculating developer fees.
- e. *Marketing Costs*—The states allow these costs as part of total development costs, but expressly prohibit any allocation to eligible basis.
- f. *Organization Costs*—Legal charged to organization costs is a part of total development costs, but is not allocable to eligible basis.

**Developer Fees.** As indicated in the format of the cost certification, developer fees can have numerous cost components, the aggregate of which will be subject to the developer fee cap set by the state. The maximum developer fee will also be subject to the fee cap elected by the developer in the application, in addition to the fee cap set forth in the developer services agreement or the agreement of limited partnership. Because the developer fee typically has a current and a deferred component, the deferred fee must be considered a valid noncontingent liability in order for the deferred component to be included in eligible basis. In general, a deferred fee will be considered a valid debt if it can be demonstrated that cash flow from the property will be sufficient to retire the deferred development fee within a 12 to 15-year period subsequent to the placed-in-service date of the project.

### Adjustments to Eligible Basis

The discussion above addresses the tax accounting and allocation of various acquisition and development costs into eligible basis. An additional analysis is necessary to arrive at the eligible basis against which the occupancy factor will be applied to arrive at qualified basis. The preparer must determine whether or not there should be any adjustments to eligible basis for the following items:

- a. The reduction to eligible basis for tax credits generated for qualifying rehabilitation expenditures for qualifying historic properties;
- b. Proceeds from a federal grant (IRC Section 42(d)(5); IRS Regulation 1.42-16). Examples of federal grants are:
  - (1) Community Development Block Grants;



- (2) Urban Development Action Grants;
  - (3) Rental Rehabilitation Grants; and
  - (4) Housing Development Grants.
- c. Examples of federal “subsidies” that are *not* considered federal grants:
- (1) Section 8 rental assistance;
  - (2) Section 9 rental assistance; and
  - (3) Rent supplement or rental assistance payments.
- d. Below-market federal loans are deducted from basis (for the purposes of the 9% credit equivalent). IRC Section 42(i)(2)(D) defines below-market as any loan funded with federal funds if the interest rate is less than the applicable federal rate under IRC Section 1274(d)(1) (as of the date on which the loan was made). Federal loans provided under the Community Development Block Grant program and the HOME Investment Partnership Act are exempt from this provision.
- e. Contingent debt.
- f. DDA or QCT “boost.” IRC Section 42(d)(5)c provides for an increase in eligible basis for a new building or the rehabilitation expenditures for an existing building when the property is located in a Difficult Development Area [IRC Section 42(d)(5)C(iii)] or a Qualified Census Tract [IRC Section 42(d)(5)C(ii)].

### State Agency Regulatory Cost Constraints

The paragraphs above discussed various components of the Internal Revenue Code, implementing regulations, and other federal authoritative standards affecting the determination of eligible basis. This discussion will review various cost constraints or limitations imposed by the states.

**Maximum Development Cost Per Housing Unit Limitation.** States may establish maximum development cost per unit policies. The purpose of these policies is to encourage the development of properties at the lowest reasonable cost. A determination is typically made at both initial credit application and final credit determination. Policies are set forth in the state’s qualified allocation plan.

**Developer Fee Limitation.** This limitation is also typically set forth in the state’s qualified allocation plan. However, the qualified allocation plans of some states incorporate other regulations by reference. Therefore, preparers may find it necessary to familiarize themselves with not only the state’s qualified allocation plan but also the state’s implementing regulations.

**Limitations on Builder Overhead, Profit, and General Requirements.** These limitations may also be included in the state’s implementing regulations. They would be inclusive of related party and unrelated party builders.

## ONGOING RESPONSIBILITIES FOR COMPLIANCE

Much of the preceding discussion focuses on the initial procedures necessary to obtain low-income housing tax credits for a project. However, as previously noted, LIHTC projects must comply with tax regulations for 15 years. Therefore, the project must meet these requirements both initially and in subsequent years. This section discusses the responsibilities of state agencies, project owners, and financial statement auditors for assessing ongoing compliance.



## Project Owner Responsibilities

**Certifications.** For each year of the 15-year minimum compliance period, IRS Regulation 1.42-5(c) requires project owners to certify on an annual basis (for the preceding 12-month period) the following items:

- a. The project met the requirements of the rent restriction and income restrictions under IRC Sections 42(g)(1)(A), (B), 142(d)(6) for New York City, and 142(d)(4)(B) for “deep rent-skewed” projects;
- b. There was no change in the applicable fraction [space devoted to low-income housing as defined in IRC Section 42(c)(1)(B)];
- c. The owner has an annual income certification from each low-income tenant and required documentation;
- d. Each unit was rent-restricted pursuant to IRC Section 42(g)(2);
- e. All units were for use by the general public and were used on a “nontransient” basis (except transitional housing for the homeless);
- f. Each building was suitable for occupancy, taking into account local health, safety, and building codes;
- g. There was no change in eligible basis of the property;
- h. All tenant facilities included in eligible basis were provided on a comparable basis without charge to all tenants; and
- i. Low-income units that became vacant during the year were first made available to applicants with qualifying income.

**Record Retention.** For each year of the 15-year minimum compliance period, the project owner must keep the following records:

- a. The total number of residential rental units in the building, including the number of bedrooms and size in square feet of each;
- b. The percentage of residential rental units in the building that are low-income units;
- c. The rent charged on each residential unit in the building, including the utility allowance;
- d. The number of occupants in each unit (buildings subject to pre-1990 rent determination only);
- e. The low-income unit vacancies in the building, and documentation of when, and to whom, the next available units were rented;
- f. The eligible basis and qualified basis of the building at the end of the first year of the credit period (including how each was calculated); and
- g. The character and use of the nonresidential portion of the building included in the building’s eligible basis (this would include separate facilities such as clubhouses or swimming pools whose eligible basis is allocated to the buildings).

Records must be maintained for six years beyond the project’s income tax filing date for each year, except for first-year records (which support the initial qualification of the project as a low-income housing project), which must be maintained for six years beyond the filing date of the final year of the project’s compliance period.

## States’ Project Monitoring Responsibility

States are required by the federal government to perform certain monitoring procedures on a specified number of LIHTC projects each year. The states’ monitoring procedures are carried out through desk audits, housing inspec-

tions and review of tenant files. If an issue of noncompliance with the requirements of the Internal Revenue Code is identified, even if subsequently remedied, it is reported to the Internal Revenue Service using Form 8823, "Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition." Forms 8823 are routinely analyzed by the IRS and could result in the examination of a taxpayer's tax return and possible recapture of previously claimed tax credits.

### **Financial Statement Auditor's Responsibility**

Noncompliance with the federal and state requirements can impact the project's financial statements. Auditors should be aware of this when conducting a financial statement audit.

Most entities are structured as partnerships, and all partnership income and tax credits would pass through to the partners. Ordinarily, this means that noncompliance that would lead to recapture of the tax credits would be obligations of the partners. However, it is believed that such a recapture event should generally be disclosed in the notes to the financial statements.

As previously noted, the developer (who often serves as the general partner in the project partnership) has an obligation to ensure that the project complies with all requirements for the 15-year compliance period. If the project (as opposed to a general partner) provides guarantees to investors regarding compliance, it would be contingently liable in the event of noncompliance. Thus, noncompliance could result in an obligation that should be recorded in the financial statements.

Auditors should obtain an understanding of the regulatory agreement with the state, the partnership agreement, and any other documentation that might describe the project's obligations regarding compliance. The auditor should view these compliance provisions in the same manner as loan and other material covenants are considered in a GAAS audit. That is, the auditor should also perform procedures as necessary to determine whether there is noncompliance that would materially affect the financial statements.



**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

38. If a project's expenditures during any 24-month period equals or exceeds the greater of 10% of the adjusted basis of the acquired building or \$3,000 or more for each low-income unit, such rehabilitation expenditures qualify as:
- a. Residential rental property.
  - b. Separate new building.
39. Which of the following is **not** an example of federal grants?
- a. Community development block grants.
  - b. Rental assistance payments.
  - c. Urban development action grants.
  - d. Housing development grants.
40. LIHTC project owners must keep numerous records for each year of the 15-year minimum compliance period. Which of the following statements is accurate regarding records that must be retained?
- a. The approximate number of residential rental units in the building.
  - b. The percentage of residential rental units in the building that are middle-income units.
  - c. The average rent charged on the total number of residential units in the building.
  - d. The low-income unit vacancies in the building and documentation detailing subsequent units rented.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

38. If a project's expenditures during any 24-month period equals or exceeds the greater of 10% of the adjusted basis of the acquired building or \$3,000 or more for each low-income unit, such rehabilitation expenditures qualify as: **(Page 185)**
- a. Residential rental property. [This answer is incorrect. Residential rental property is defined as any building or structure that derives 80% or more of its gross rental income from dwelling units.]
  - b. Separate new building. [This answer is correct. IRC Section 42(e)(3) requires expenditures during any 24-month period to equal or exceed the greater of 10% of the adjusted basis of the acquired building or \$3,000 or more for each low-income unit in order for those rehabilitation expenditures to qualify as a separate new building.]**
39. Which of the following is **not** an example of federal grants? **(Page 189)**
- a. Community development block grants. [This answer is incorrect. Community development block grants are one example of federal grants.]
  - b. Rental assistance payments. [This answer is correct. Rental assistance payments are an example of federal "subsidies", not federal grants.]**
  - c. Urban development action grants. [This answer is incorrect. Another example of federal grants are urban development action grants.]
  - d. Housing development grants. [This answer is incorrect. Housing development grants are an example of federal grants.]
40. LIHTC project owners must keep numerous records for each year of the 15-year minimum compliance period. Which of the following statements is accurate regarding records that must be retained? **(Page 190)**
- a. The approximate number of residential rental units in the building. [This answer is incorrect. Records must be retained detailing the total number of residential rental units in the building, including the number of bedrooms and size in square feet of each.]
  - b. The percentage of residential rental units in the building that are middle-income units. [This answer is incorrect. LIHTC project owners must keep records on the percentage of residential rental units in the building that are *low-income* units.]
  - c. The average rent charged on the total number of residential units in the building. [This answer is incorrect. The project owner must retain records detailing the rent charged on each residential unit in the building, including the utility allowance.]
  - d. The low-income unit vacancies in the building and documentation detailing subsequent units rented. [This answer is correct. LIHTC project owners are required to keep records covering the low-income vacancies in the building, and documentation detailing when, and to whom, the next available units were rented.]**

**EXAMINATION FOR CPE CREDIT****Lesson 3 (HUDTG092)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

32. Which of the following is **not** one of the provisions required by federal law that the project must meet to receive the low-income housing tax credit?
- a. Be new construction expenditures on residential property.
  - b. Be rehabilitation expenditures on residential property.
  - c. Be new construction expenditures on commercial property.
  - d. Operate in compliance with applicable requirements for a minimum of 15 years.
33. The language of the organizational agreement of the project owner or the mortgage usually determines the audit requirements for low-income housing tax credit projects. The partnership agreement usually requires an annual GAAS audit, especially for projects with:
- a. 9 or more units.
  - b. 10 or more units.
  - c. 11 or more units.
  - d. 12 or more units.
34. It is common for competitively allocated credit projects to be neither completed nor placed in service during the year of the preliminary allocation. Under IRC Section 42(h)(1)(E), the credits can remain valid so long as the qualified building is placed in service before the end of the second calendar year following the calendar year in which the allocation is made, and the taxpayer's basis at the end of the allocation year is more than \_\_\_\_\_ of the taxpayer's reasonably expected basis in the project upon completion.
- a. 7%.
  - b. 8%.
  - c. 9%.
  - d. 10%.
35. When applying the threshold tests for bond capitalization projects, which of the following are considered *good* costs?
- a. Costs incurred prior to the date of bond inducement.
  - b. Land and building costs.
  - c. Partnership organizational costs.
  - d. Bond issuance costs.

36. IRC Section 168(e)(2) defines residential rental property as any building or structure that derives \_\_\_\_\_ of its gross rental income from dwelling units.
- a. 50% or more.
  - b. 60% or more.
  - c. 75% or more.
  - d. 80% or more.
37. Which of the following "other costs" related to the initial completion of the LIHTC project is allocated to eligible basis?
- a. Permit processing fees.
  - b. Capital fees.
  - c. Marketing costs.
  - d. Organization costs.
38. Which of the following is **not** an example of federal "subsidies"?
- a. Section 8 rental assistance.
  - b. Section 9 rental assistance.
  - c. Rental rehabilitation grants.
  - d. Rent supplement.
39. IRS Regulation 1.42-5(c) requires LIHTC project owners to periodically certify a list of specified items. At what interval must such certifications occur?
- a. Every 6 months.
  - b. Every 9 months.
  - c. On an annual basis.
  - d. On a semiannual basis.
40. LIHTC project owners' records, with the exception of first-year records which must meet a different requirement, must be maintained for \_\_\_\_\_ beyond the project's income tax filing date for each year.
- a. Six years.
  - b. Seven years.
  - c. Eight years.
  - d. Nine years.



## GLOSSARY

**Amortization:** Reduction of a debt by periodic charges to assets or liabilities, such as payments on mortgages.

**Capital advance program:** A program that provides funding in the form of a capital advance (grant) to finance the construction, rehabilitation or acquisition of housing by very low income individuals, elderly persons, or persons with disabilities, through an annual competitive application process. Repayment of the capital advance is not required provided the housing remains available for occupancy by very low-income individuals of the target population for at least 40 years.

**Cash equivalence:** The market value of an item if sold for cash. In real estate it represents the value of property sold, which can be different from the stated selling price.

**Coinsured mortgage:** A mortgage in which the insurer provides indemnity for only a certain percentage of the insured's loss, reflecting the relative division of risk between insurer and insured.

**Default:** Failure of a debtor to make timely payments of interest and principal as they come due or to meet some other provision of a bond, mortgage, lease, or other contract.

**Disbursement:** Paying out of money in the discharge of a debt or an expense.

**Indemnify:** To insure; to secure against loss or damage that may occur in the future; to compensate for loss or damage already suffered.

**LIHTC program:** The LIHTC program is an indirect Federal subsidy used to finance the development of affordable rental housing for low-income households.

**Marketable debt securities:** Debt securities that are easily sold. On a corporation's balance sheet, they are debts that can be readily converted into cash such as government securities, banker's acceptances, and commercial paper.

**Mark-to-Market (M2M) restructuring program:** Involves the restructuring of debt on certain multifamily properties insured by the Federal Housing Administration (FHA) that have above market rents on their Section 8 contracts.

**Mortgage:** Debt instrument by which the borrower (mortgagor) gives the lender (mortgagee) a lien on property as security for the repayment of a loan.

**Mortgagee:** One who holds a lien on property or title to property as security for a debt; lender with collateral.

**Mortgagor:** One who pledges property as security for a loan.

**Mortgage insurance:** Insurance that is generally required by lenders of those who borrow 90% of a home's price. It will indemnify the lender in case of foreclosure of the loan. Indemnification is typically limited to losses suffered by the lender in the foreclosure process, up to 20% of the home's cost.

**Multifamily housing:** A residential structure with more than one dwelling unit in the same building.

**Operating expense:** The amount paid to maintain property, such as property taxes, utilities, hazard insurance.

**Residual receipts account:** Account established by a project owner if distributions of cash to the owners are limited or not permitted.

**Rent subsidy program:** Payment of rent by the government to certain individuals or groups of economic entities, usually to encourage their continued existence, growth, development, and profitability.

**Risk-sharing program:** A mortgage insurance program that is combined with construction and permanent financing for the creation of multifamily rental housing.

**Section 8 program:** The Section 8 program is HUD's major program for assisting very low income families, the elderly, and people with disabilities in affording decent, safe, and sanitary housing in the private market.

**Surplus cash:** The remainder of a fund appropriated for a particular purpose.

**Title I loans:** HUD loans that are used primarily for property improvements or for purchases of manufactured homes, such as mobile homes.

**Title II loans:** HUD loans that are used to provide financing to owners of single family and multifamily housing.

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10. ○	○	○	○	20. ○	○	○	○	30. ○	○	○	○	40. ○	○	○	○

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Your Name (optional): \_\_\_\_\_ Date: \_\_\_\_\_

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Please indicate your answers by filling in the appropriate circle as shown:

Fill in like this ☒ not like this ☐ ☐ ☒.

Satisfaction Level:	Low (1) . . . to . . . High (10)									
	1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
2. How would you rate the examination related to the course material?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
3. Does the examination consist of clear and unambiguous questions and statements?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
4. Were the stated learning objectives met?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
5. Were the course materials accurate and useful?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
7. Was the time allotted to the learning activity appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
8. If applicable, was the technological equipment appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
10. If applicable, how well did the audio/visuals contribute to the program?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.

(Please print legibly):

### Additional Comments:

1. What did you find **most** helpful? \_\_\_\_\_
2. What did you find **least** helpful? \_\_\_\_\_
3. What other courses or subject areas would you like for us to offer? \_\_\_\_\_
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? \_\_\_\_\_
5. How many employees are in your company? \_\_\_\_\_
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. Yes/No ☐ ☐

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## TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

### Companion to PPC's Guide to HUD Audits—Course 2—HUD Multifamily Housing, Compliance Audits, and Low-Income Housing Tax Credit Projects (HUDTG092)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

**ONLINE GRADING.** Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

**PRINT GRADING.** If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation**, and payment to:

**Thomson Reuters  
Tax & Accounting—R&G  
HUDTG092 Self-study CPE  
36786 Treasury Center  
Chicago, IL 60694-6700**

You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

Please allow a minimum of three weeks for grading.

**Note:** The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.
3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of \$75. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is \$214 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is \$270 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is \$319 (a 15% discount on all five courses or more).
4. To receive CPE credit, completed answer sheets must be postmarked by **September 30, 2010**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional \$24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.
5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.
6. Please direct any questions or comments to our Customer Service department at (800) 323-8724.

**EXAMINATION FOR CPE CREDIT**

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

	<b>Page</b>
<b>CPE Examination Questions (Lesson 1)</b> .....	<b>135</b>
<b>CPE Examination Questions (Lesson 2)</b> .....	<b>173</b>
<b>CPE Examination Questions (Lesson 3)</b> .....	<b>195</b>

# EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to HUD Audits—Course 2—HUD Multifamily Housing, Compliance Audits, and Low-income Housing Tax Credit Projects (HUDTG092)

Price \$75

First Name: \_\_\_\_\_

Last Name: \_\_\_\_\_

Firm Name: \_\_\_\_\_

Firm Address: \_\_\_\_\_

City: \_\_\_\_\_ State /ZIP: \_\_\_\_\_

Firm Phone: \_\_\_\_\_

Firm Fax No.: \_\_\_\_\_

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Credit Card Number: \_\_\_\_\_ Expiration Date: \_\_\_\_\_

Birth Month: \_\_\_\_\_ Licensing State: \_\_\_\_\_

## ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ○

a	b	c	d	a	b	c	d	a	b	c	d	a	b	c	d
1. ○	○	○	○	11. ○	○	○	○	21. ○	○	○	○	31. ○	○	○	○
2. ○	○	○	○	12. ○	○	○	○	22. ○	○	○	○	32. ○	○	○	○
3. ○	○	○	○	13. ○	○	○	○	23. ○	○	○	○	33. ○	○	○	○
4. ○	○	○	○	14. ○	○	○	○	24. ○	○	○	○	34. ○	○	○	○
5. ○	○	○	○	15. ○	○	○	○	25. ○	○	○	○	35. ○	○	○	○
6. ○	○	○	○	16. ○	○	○	○	26. ○	○	○	○	36. ○	○	○	○
7. ○	○	○	○	17. ○	○	○	○	27. ○	○	○	○	37. ○	○	○	○
8. ○	○	○	○	18. ○	○	○	○	28. ○	○	○	○	38. ○	○	○	○
9. ○	○	○	○	19. ○	○	○	○	29. ○	○	○	○	39. ○	○	○	○
10. ○	○	○	○	20. ○	○	○	○	30. ○	○	○	○	40. ○	○	○	○

You may complete the exam online by logging onto our online grading system at **OnlineGrading.Thomson.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: **September 30, 2010**

## Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to HUD Audits—Course 2—HUD Course Acronym: HUDTG092  
Multifamily Housing, Compliance Audits, and Low-income Housing Tax Credit Projects

Your Name (optional): \_\_\_\_\_ Date: \_\_\_\_\_

Email: \_\_\_\_\_

Please indicate your answers by filling in the appropriate circle as shown:

Fill in like this ☒ not like this ☐ ☐ ☒.

Satisfaction Level:	Low (1) . . . to . . . High (10)									
	1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
2. How would you rate the examination related to the course material?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
3. Does the examination consist of clear and unambiguous questions and statements?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
4. Were the stated learning objectives met?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
5. Were the course materials accurate and useful?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
7. Was the time allotted to the learning activity appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
8. If applicable, was the technological equipment appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
10. If applicable, how well did the audio/visuals contribute to the program?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.

(Please print legibly):

### Additional Comments:

- What did you find **most** helpful? \_\_\_\_\_
- What did you find **least** helpful? \_\_\_\_\_
- What other courses or subject areas would you like for us to offer? \_\_\_\_\_
- Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? \_\_\_\_\_
- How many employees are in your company? \_\_\_\_\_
- May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. Yes/No ☐ ☐

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